No. 9242

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

West Coast Life Insurance Company (a corporation), Pacific National Bank of San Francisco (a national banking association), et al.,

Appellants,

vs.

Merced Irrigation District ~~and Reconstruction Finance Corporation~~,

Appellees.

BRIEF FOR APPELLEE MERCED IRRIGATION DISTRICT.

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BRIEF FOR APPELLEE MERCED IRRIGATION DISTRICT.

SUPPLEMENTAL STATEMENT OF CASE.

The following supplement to appellants' statement of the case will clarify the issues involved.

Default and Attempts to Refinance.

Prior to actual default of the district it was clear that default was imminent and in the spring of 1931 the bondholders began to organize for the protection of their investments (R. 495). Since that time and up to the present, the history of the district has been one of constant refinancing negotiations. From the outset it was recognized

by the district and bondholders alike that refinancing was necessary. The only difference of opinion was as to the manner in which it should be accomplished (R. 495, 496). The cash offer of $515.01 for each $1000 bond was the final culmination of the efforts of the bondholders to protect their investments before all value should be destroyed. It became possible only after Congress had authorized Reconstruction Finance Corporation* loans to effectuate irrigation district reorganizations.

At the first conferences in 1931 the bondholders appeared informally. Subsequently two bondholders' protective agencies were formed (R. 495). Later these two agencies were merged into what is known as Merced Irrigation District Bondholders' Protective Committee which subsequently carried on elaborate negotiations with the district (R. 495-509). Either individually or through their protective committee or as a group of dissenting bondholders it may be said that since the first default in 1931 the security holders have actively and aggressively been seeking to preserve the value of their bonds to the full extent justified by the economic condition of the district. It would not be accurate to say that at all times the district and bondholders agreed, but it is true that the district to the best of its ability has cooperated with the bondholders in an effort to elicit all relevant facts and to put the district on an "ability to pay" basis.

*Referred to throughout this brief as R. F. C.

Investigations and Studies.

The record shows the most comprehensive investigations and surveys of the district by engineers, auditors and agricultural experts. These studies were made either by the bondholders alone, or, as in the case of the Benedict economic report hereafter referred to, jointly by the bondholders and the district. The district paid all of the expenses (R. 372). In addition many of the bonds were held by banks, and large corporations which had at their finger tips resources of statistical organizations, and from 1931 these were utilized to determine the maximum load the district could carry.

A letter from the bondholders' committee to the bondholders dated December 15, 1933 (Ex. 37, R. 736), gives a vivid picture of the extent and nature of these studies and what they revealed as to the district's critical financial condition as of that time. The basic reasons underlying the district's inability to carry its bonded debt are also graphically set forth. They are referred to later.

During the early negotiations every attempt was made to marshal the facts carefully but natural differences of opinion developed and by the early part of 1932 it was deemed desirable to have an economic study made by a thoroughly competent and impartial agency in order to determine the taxpaying abilities of the lands in the district. Accordingly a joint request was made on the University of California by the district and the bondholders' committee to make such study (R. 434) and what is known as the "University of California", or the "Giannini Foundation" or "Benedict" report was the result. We shall hereafter refer to it as the Benedict report.

The Benedict Report on Tax Paying Ability.

Dr. Benedict, an agricultural statistician with a national reputation, was in charge (R. 432-435), and under him was a group of experienced assistants aided by a fact finding committee. In addition Mr. Robert Fullerton, Jr., vice president of the bondholders' committee and director of the Citizens Commercial Trust and Savings Bank of Pasadena (R. 508), representing heavy bondholdings, was appointed by the bondholders' committee to serve as an observer. Arrangements were also made by the bondholders' committee with R. L. Underhill, an engineer, to act as an observer with J. S. Cone in classification and appraisal of the lands (R. 435). The report was completed in about nine months of intensive work (R. 435). It is an outstanding, scientific study of tax paying ability and was introduced in evidence with the testimony of Dr. Benedict (R. 432, et seq.) as Ex. 35. It is a separate volume in this record of about 133 printed pages.

At the inception of the study the lands in the district were first classified and appraised by Mr. Cone with Mr. Underhill acting as observer. The classification and appraisal is set forth at pages 126 to 130 of the Benedict report (Ex. 35). It was found there was no market value for the lands in the district as of that time. The few buyers of farm lands had gone elsewhere. To set any value at all upon the lands it was necessary, among other things, to assume:

(a) that within a reasonable period of time a settlement permanent in its nature between the bondholders and the district should be arrived at based upon "ability to pay";

(b) that there would be an upward revision of farm product prices reaching a level fairly comparable to the price levels of 1910 to 1914;

(c) that the district should be able to control the increasingly high water table and that the rapid spread and growth of noxious weeds and grasses should be abated (Ex. 35, p. 127).

Based on these assumptions, a value of $100 per acre was placed on all lands graded at 100% and values on the rest of the lands in proportion to their percentage gradings. Grade One included all lands of 85% and above; Grade Two, 60% to 80% and Grade Three, all lands under 60% (the marginal areas). The result showed the following:

Grade I	38,607	acres
Grade II	52,151	"
Grade III	80,852	"
Total	171,610	"

(Total value $10,518,307 on the assessment roll) (Ex. 35, pp. 128-130).

The testimony of Dr. Benedict and his report showed that as a "net-over-costs" for out-of-pocket cash expenses, labor and county taxes for the years 1929-30-31, all of the property in the district being farmed, as an average, operated at a loss for said three years with the exception of the Grade One lands in 1929. Taking the same figures for the same three years but including depreciation, all the properties were being farmed at a heavy loss (R. 437; Ex. 35, pp. 68-69). His study further showed that

for 1926-27-28 all of the properties were being farmed at a heavy loss (Ex. 35, pp. 114-124). On the properties selected as a sample, for 1926-27-28 the total net income before the payment of taxes and irrigation assessments was minus $246,872; net income after taxes and assessments for the three years was minus $1,389,019 (R. 440-441). Most of the assessments that were paid were not being "yielded" by the lands (R. 441, 442, 456). In "considerable part" they came from outside sources (R. 442). They were based on hopes and prayers for later improvements in value. Dr. Benedict's study and report covered six years of operations but was designed to show what the district should be able to pay in irrigation assessments over the period of the bond issue. 1926-1930 were good agricultural years—better on the whole than the years that followed (see index figures for California Farm Prices, R. 436, also Report U. S. Dept. Agriculture, Ex. 34, R. 733).[1]

At the trial the witness Momberg (manager of California Lands, Inc., at Merced, a heavy operator in the district) further supplemented and confirmed Dr. Benedict's evidence. His testimony covered the years subsequent to 1932 up to and including the year 1938 (R. 472) and showed substantially the same situation for those years that Dr. Benedict had found for 1926-1931. Thus practically the entire period that the district has been operating was covered by the testimony of these two witnesses.

1. Through error the U. S. Dept. of Agriculture Report inserted in the record did not include the latest one issued up to the date of trial, Nov. 1, 1938. The index figures for 1938 are quoted in Appendix "A". The court takes judicial knowledge of the report.

We pause to remark that an irrigation district cannot be operated successfully unless the farmer can operate the land to make a profit and pay taxes. Unless he can be kept on the land and assessments kept within "ability to pay" default is inevitable. The Benedict report and the early investigations made by the bondholders themselves show that payments did not come from the land but from outside sources. When these were exhausted it was obvious that collapse would follow and that is why from the very first it was recognized that refinancing was essential (R. 495, 496).

Bondholders' Letter of December 15, 1933.

The letter of the bondholders' committee to the bondholders dated December 15, 1933 (Ex. 37, R. 736) states that there are approximately 90,000 acres in the district that may be classified as "good lands" and 80,000 acres which taken as a whole, are not able to carry a substantial part of the district's obligations. Of the 90,000 acres of good land it is stated there are some 17,000 acres above the level of the gravity distribution of water in respect to which the delivery of water is largely at a loss, leaving approximately 74,000 acres upon which the burden of the district's obligations largely rests (R. 742; see, also, R. 516).

Other factors contributing to the default according to this letter were the inability to colonize the district, and the irregularity of annual power revenue.[2]

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2. This varied from a low of approximately $95,000 in 1931 to a high of approximately $707,000 in 1938 (R. 407).

The letter is signed, among others, by Milo W. Bekins, Reed J. Bekins, Victor Etienne, Jr., Honorable James N. Gillett and Myford Irvine, who appear in the pending proceeding either personally or in a representative capacity as dissenting bondholders and appellants holding a large volume of the dissenting bonds (R. 5, 501, 505, 885).

In addition, the following should be noted: First, the district was grossly over-capitalized. At the inception of the project $5,500,000, or over one-third of the total bond issue, was expended to relocate the Yosemite Valley Railroad (R. 510). From the standpoint of economic return this represented no useful purpose and was a total loss; also, there has been an inability to sell property taken over by the district for delinquency (R. 512). Some improvement is noticeable recently in the market for sale of the district's lands based on the assumption that the refinancing will be completed at the R. F. C. price. If the outstanding issue of $16,190,000 were serviced, the resultant delinquency would plainly make all sales impossible.

First Refunding Plan.

In the latter part of 1933 and after the Benedict report had been received and studied, the district and the bondholders' committee informally reached an agreement on a refunding plan (Ex. 37, R. 737) which the district officially approved at an election (R. 512). This plan will be spoken of as the "first refunding plan." It is also spoken of in the testimony as the refunding plan of 1933 (R. 499). It contemplated that the old issue of $16,190,000 would be exchanged for refunding bonds in the same principal

amount, all to become due simultaneously in fifty years, namely, in 1983 (Ex. 37, R. 749). In other words, there was to be an exchange of one bond for another of the same principal amount and with no change in interest except for a seven year period during which the fixed interest was reduced and contingent interest was provided for (Ex. 37, R. 748). It was further agreed the district was to apply for federal or state aid "in the repurchase or refinancing" of the bonds in the event funds were made available from a "Federal or State agency" (R. 752).

Prior to the informal agreement on the first refunding plan the bondholders' committee had been accepting deposit of bonds under a deposit agreement dated March 1, 1932 (Ex. 11, R. 576). Under the terms of this deposit the committee could adopt such plan of refinancing as it saw fit but any bondholder upon being notified of the plan could withdraw his bonds within a period of thirty days upon payment of his prorata of the committee's expenses (Ex. 11, R. 576-578). When the first refunding plan was informally agreed to there were about 35% of the bonds on deposit with the committee pursuant to the agreement of March 1, 1932 (R. 737).

Upon approval by the district of the first refunding plan, the bondholders' committee employed men to solicit deposit of bonds under the plan (R. 496). The bondholders were advised, however, that additional outstanding bonds had to be deposited with the committee to enable it formally to adopt the plan (Ex. 37, R. 737). They were also told that the committee would cooperate in any application to secure federal or state aid. It was clear

that no bank or underwriter would advance money to refinance the district and any cash must come from relief agencies of the state or federal government. Until money should be so made available a paper exchange was the only way to refinance, although of course essentially that gave the bondholders nothing.

It also became increasingly clear as time went by that the first refunding plan would not be accepted by a substantial percentage of bondholders. Over a year later, notwithstanding intense solicitation in the meantime for the first refunding plan, "just short of 60%" (R. 499, 497) of the bonds had been deposited (not 80% as appellants say p. 6 of their brief[3]), whereas within a few months after the adoption of the cash plan by the committee on February 15, 1935 (R. 586) nearly 90% of the bonds were deposited (R. 344). Furthermore, it became obvious almost immediately after the first refunding plan had been approved by the district that it could not carry it out. The district attempted to operate under it but in less than a year defaulted to the extent of about $390,-000 (R. 512).

R. F. C. Loan and Cash Plan.

In the meantime district representatives went to Washington and made application for an R. F. C. loan (R. 497). On November 14, 1934, a resolution was passed approving a loan (Ex. OO, 155) which would enable the district to pay $515.01 for each $1000 bond. The amount of the loan was, of course, based on a careful appraisal

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3. All references to appellants' brief are to their main brief unless otherwise noted.

of the "loan value" of the district based upon its "ability to pay." It was necessarily higher than the maximum loan value to a private banker or underwriter[4] because the R. F. C. lends at 4%. This lower cost of money is reflected in a decreased cost of bond service to the landowner, making it possible for him to carry a higher loan. For example, a $3.00 tax rate (which we will assume represents the "ability to pay" rate) might service a bond issue at 4% to the R. F. C. but it would not service a bond issue in the same principal amount at 6%.

The agreement of the R. F. C. to make the loan, however, was subject to certain conditions which, among other things, provided for purchasing and keeping the old bonds alive until all had been deposited for refinancing (Ex. OO, 159 (b), 164 (c), 165 (d)). These terms and conditions will be discussed later in detail under Proposition Two. The district accepted the resolution and the terms and conditions thereof on December 11, 1934 (Ex. OO, 180) and on February 11, 1935, adopted a refunding plan based thereon (Ex. OO, 183, and note p. 189 (3)) which was later approved by the electors of the district (Ex. 14, R. 603-606).

The district submitted the cash offer of $515.01 for each $1000 bond to the bondholders' committee (R. 496) and to the bondholders (R. 761). There followed considerable negotiations and discussion culminating in a referendum which the committee submitted to the bondholders.

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4. There is no evidence of any private banker or underwriter being willing to refinance at any price.

Referendum on Cash Plan.

By this referendum the bondholders were asked whether they preferred the so-called first refunding plan (exchanging their bonds for another bond due in fifty years) or cash in the sum of $515.01 for each $1000 bond (R. 499). The holders of $10,221,000, or approximately 63% of all bonds outstanding, voted in favor of the cash plan and $1,147,000, or 7% of bonds outstanding, voted for the refunding plan of December 1933 (R. 499), a majority of nearly ten to one in favor of cash. In number of bond holders, 658 voted in favor of the cash plan and 141 in favor of the refunding plan of December 1933, nearly five to one in favor of cash. Fifty-eight expressed no preference (R. 503). Not the committee, therefore, but the bondholders themselves by an overwhelming majority expressed the choice.

February 15, 1935, the bondholders' committee, on the basis of the referendum officially approved the cash plan and notified all depositing bondholders they could withdraw their bonds within thirty days upon payment of their proportion of the expenses of the committee, otherwise the committee would deposit all bonds in its hands under the cash plan (Ex. 13, R. 586-596). About 2% withdrew (R. 499). Two months later (April 18, 1935) 75% of the bonds had been deposited under the cash plan (Ex. OO, 23, 40) and the district filed a proceeding under Section 80 of the Bankruptcy Act for confirmation (R. 518). This is called the first bankruptcy case.

Purchase of Deposited Bonds by R. F. C.

On October 4, 1935, there were approximately $14,071,000 of bonds on deposit under the cash plan (R. 344). Thereupon the R. F. C. authorized purchase of all deposited bonds at the settlement figure (R. 344 and Ex. 10, R. 557) pursuant to an agreement with the district dated August 14, 1935 (Ex. OO, 217). (See, also, agreement of September 16, 1935, Ex. OO, 202).

Under the first named agreement the R. F. C. was to purchase all deposited bonds. The district bound itself "expeditiously and in good faith" to continue to secure deposit of bonds until all of the old bonds were available for refinancing. In the interim the bonds purchased by the R. F. C. were to continue as outstanding obligations for the full amount thereof. Upon presentation or deposit of all of the outstanding bonds at the settlement figure, refinancing was to be completed by cancellation of the old bonds and issuance of refunding bonds to the R. F. C. An interim interest payment of 4% annually to R. F. C. on the money used to purchase the old bonds was agreed to. Detailed discussion of the legal relations of the R. F. C. and the district is set forth in the answer to First Proposition.

To date refinancing has not been completed because the dissenting bondholders have not turned in their bonds. Hence the old bonds continue as outstanding obligations. They have not been cancelled or surrendered nor have refunding bonds been issued to the R. F. C. (R. 361). All old bonds, however, are purchased by the R. F. C. whenever offered at the settlement figure (R. 351).

Pursuant to instructions from the R. F. C., dated September 19, 1935 (Ex. 10, R. 557), the Federal Reserve Bank on October 6, 1935, proceeded to purchase the deposited bonds for the account of the R. F. C.

The cash plan provided that, in addition to the $515.01 for each $1000 bond, depositing bondholders should be paid by the district 4% on the settlement figure from the date of deposit until funds should actually be made available to take up the deposit (Ex. 13, R. 586-591). In other words, during the period that the bondholder had surrendered his bond and until money was available to fulfill the conditions of the escrow, he was to receive 4% upon the liquidating figure (R. 354, 367).

Money became available on October 4, 1935 and ever since has been available at the settlement figure (R. 351). But from the date of deposit under the cash plan until October 4, 1935, interest accrued on deposited bonds from varying dates at 4% on the settlement figure, totaling $168,027.31 (R. 368). This interest was paid by the district pursuant to the cash plan at the time the R. F. C. made disbursement on October 4, 1935 (R. 368). No interest has been paid to depositing bondholders since that date as the R. F. C. has continued to take up bonds pursuant to the cash offer whenever presented (R. 351). The district has, however, made the interim payments of 4% annually to the R. F. C. (R. 764).

Proceedings After Purchase of Bonds by R. F. C.

The trial of the first bankruptcy action under Section 80 was held in February 1936 (R. 518). The plan was confirmed (Ex. OO, 222). Dissenting bondholders ap-

pealed (Ex. OO, 324). Before the record was printed, the Supreme Court in *Ashton v. Cameron County Water Improvement District,* 298 U. S. 513, 56 S. Ct. 892, 80 L. Ed. 1309, held Section 80 of the Bankruptcy Act unconstitutional. Thereafter on the 17th day of March, 1937 dissenting bondholders made a motion to dispense with printing of the record and to reverse the case on the authority of the *Ashton* case (Ex. OO, 333). This motion was granted by the Circuit Court of Appeals April 12, 1937 (Ex. OO, 338), 89 Fed. (2d) 1002. The district then filed a petition for certiorari which was denied by the Supreme Court October 11, 1937 (R. 519), 302 U. S. 709, 58 S. Ct. 30, 82 L. Ed. 548). Thereafter the case in the District Court was dismissed for want of jurisdiction. It is claimed by appellants that this judgment is *res judicata* here.

In the meantime and prior to the enactment of Sections 81-84 of the Bankruptcy Act on August 16, 1937, the State of California on March 30, 1937, enacted what is known as the Irrigation District Refinancing Act (Stats. 1937, Chap 24). That Act provides that an irrigation district may, with the consent of two-thirds in amount of its creditors, present a plan of refinancing and if the court, among other things, finds the plan fair, public necessity for the condemnation of the dissenting bonds is found and thereafter the case proceeds as a condemnation action. On July 20, 1937, the district filed under that Act in the Superior Court in Merced and the case proceeded to trial in January 1938 (R. 519). In March 1938, the court handed down an opinion that the plan was fair (R. 381) and directing the preparation of an interlocutory

judgment pursuant to the Act (Sec. 8) which, if entered, would have established the right to condemn. No findings or judgment, however, was entered (R. 384) and nothing further has been done because on April 25, 1938, the United States Supreme Court in *United States v. Bekins,* 304 U. S. 27, 58 S. Ct. 811, 82 L. Ed. 1137, held Sections 81-84 constitutional. Accordingly the district elected on June 17, 1938, to proceed under this Act in bankruptcy and filed this proceeding (R. 8, 36).

In closing this general summation it should be stated the evidence shows without any doubt that the district was hopelessly insolvent and unable to meet its debts as they matured. Not one of the dissenting bondholders seriously asserted at the trial that the district could pay its bonded debt of $16,190,000 plus millions of dollars in defaulted interest. The legal tax rate in September, 1939, if an attempt were made to service the old bond issue, would be $68.83 per $100 assessed valuation (R. 402; Exs. 22, 23, R. 661-663). The district defaulted 62.80% on its last attempt to levy for bond service in September 1932 (R. 402). At that time the rate was $8.90 per $100 and the current amount then required for bond service was $954,400, whereas the peak amount required for bond service would not be reached until the year 1951 when $1,280,700 would have to be raised (R. 404, and note Ex. 24, R. 666, photostat of chart representing bond service costs to date of maturity old bond issue).

Fortunately the "pyramiding" of delinquencies which results in the virtual disappearance of the landowner from the district *(Provident Land Corporation v. Zumwalt,* 12 Cal. (2d) 365 at 371) and under which the "power of

taxation'' becomes ''useless'' and the ''creditors of the district'' become ''helpless'' (per Chief Justice Hughes in the *Bekins* case *supra,* 82 L. Ed. at 1145) and under which annual assessments in each succeeding year ''fall upon a progressively lessening body of land'' which in turn is ''forced to default in greater and greater quantities'' thereby destroying the ''ability of such districts to pay their bonded debts in whole or in part'' (R. 429-432) stopped with the levy of the assessment in 1932 (R. 409). Following the delinquencies of 62.80% on that levy, the district availed itself of emergency legislation which permitted the levy of an emergency rate in accordance with the ability of the land to pay and as approved by the California Districts Securities Commission (Sec. 11, Cal. Stats. 1933, Chap. 60, Chap. 36 Stats. 1935, R. 402).[5] The emergency rates since 1932 have been as follows: 1933, $1.00; 1934, $1.70; 1935, 1936, 1937 and 1938, $3.00 per $100.00 (R. 403).[6] Based on this lowered assessment rate the law of diminishing returns has been reversed, the vicious circle resulting in pyramiding has been broken and delinquencies have dropped materially. In addition, landowners have taken advantage of emergency legislation permitting ten year installment payments on past delinquencies (R. 405). The lowered tax rate, coupled with very high revenue from sale of power for three years, has resulted in improved conditions in the financial affairs of the district. This improved condition, however, is due to the fact that the district, for practical purposes, has been operating as if the R. F. C. refunding plan were in

5. Extended by subsequent amendments.

6. For reports of the Districts Securities Commission showing that these rates are based on "ability to pay" and confirming them (see Exs. 29 to 33A, R. 678 to 732).

effect and no futile and dangerous attempt has been made to service the outstanding bond issue of $16,190,000.

No plan of refinancing, except the cash plan, ever met with substantial approval of the bondholders. In fact, no other plan was even seriously suggested except the "first refunding plan" which the bondholders themselves rejected (R. 499) and which experience showed at the very inception to be unworkable and impossible for the district to carry out (R. 512, 514).

The bonds of the district were selling as low as sixteen and eighteen cents on the dollar prior to the time that R. F. C. granted the loan (R. 500). And it is a fair deduction from the evidence that they would have little or no value except for the underwriting of the cash plan by the R. F. C. In other words, the plan of composition does not take from the bondholders any of the value of their bonds. In large degree that was already gone. The cash plan and the support accorded by the R. F. C. gave the bonds a value they would not otherwise have had and enabled the bondholders to salvage over 50% of a principal investment which had largely been lost.

So clear was the testimony (1) that refinancing was necessary if anything were to be salvaged on the bonds, and (2) that the cash plan was the only practicable refinancing plan, that appellants primarily present their case on the claim that the district has already been refinanced through the operation of the R. F. C. and the old bonds purchased by it have, in effect, ceased to be outstanding obligations and have been cancelled. Therefore, it is argued that the principal debt structure is not $16,190,000 but the amount of the dissenting bonds in full in the principal sum of $1,488,000 plus $7,570,871.60

used by the R. F. C. to buy up deposited bonds (Ex. AA, R. 888), making an alleged total principal debt structure of $9,058,871.60. It is then argued that the district has the ability to pay a debt of this amount, thereby giving appellants payment of their bonds in full and proving (so it is claimed) that the district plan (if not appellants' reasoning) is unfair. But the major premise finds no support in law, logic, equity or fair dealing and, as we shall see in the next subdivision hereof, is utterly at variance with the contracts and intention of the parties and with the admitted facts.

ANSWER TO FIRST PROPOSITION: "THE RECONSTRUCTION FINANCE CORPORATION IS NOT A CREDITOR AFFECTED BY THE PLAN OF COMPOSITION AND ITS CONSENT IS NOT ENTITLED TO BE CONSIDERED."[7]

A. The Court Found the Bonds are Owned by the R. F. C. and are Outstanding. The Issue is Primarily One of Fact, Not of Law.

The trial court (25 Fed. Sup. 981; R. 168) held that the clear effect of the evidence is that the R. F. C. is a creditor in the full amount of the bonds purchased; points out that unconditional bills of sale were given to it except in a few instances where they were waived; that all bonds so acquired were duly registered in its name as owner and since their delivery have been subject to its sole control. It finds that the clear intent of all parties was that the

7. Since the writing of the following section of this brief the Supreme Court on November 6th denied certiorari in *Luehrmann v. Drainage District No. 7*, 104 Fed. (2d) 696. This case is reviewed at pages 55 et seq. infra, but aside from other considerations advanced there, the case is direct authority that the R. F. C. is a creditor affected by the plan in the full amount of the bonds held by it. All contentions of appellants relating to R. F. C. status are answered by this case. Ours is even a stronger case since there the bonds were admittedly held in pledge. If the *Luehrmann* case is accorded full weight it renders consideration of the following section by the court unnecessary. We therefore cite it at the beginning.

bonds were to be kept alive and available for further protection of the R. F. C. until such time as it concedes that refinancing is complete. The formal findings of fact were to the same effect (R. 214-215). There was ample evidence to sustain these findings. In fact, it is difficult to understand how the evidence would have sustained a contrary finding. The trial court says, at page 984, R. 171:

> "No one can read the record of the negotiations between the governmental agency and the insolvent District and its security holders and fail to conclude that the paramount, imperative and essential feature of the contract was the ultimate and not the immediate retirement of the outstanding bonds which the R. F. C. acquired."

B. The Evidence Sustains the Finding.

Briefly summarized, the evidence showed the following: On November 14, 1934, the R. F. C. passed a resolution authorizing a loan to or for the benefit of the district "subject to * * * conditions" (Ex. OO, 157). Disbursement was to be made——

> "to or for the benefit of the Borrower *through the purchase of securities*[8] issued or to be issued by the Borrower or upon promissory notes collateraled by the obligations of the Borrower * * *" (Ex. OO, 159(b)).

> "All or any part of the Old Securities acquired or held * * * through any disbursement * * * as well as all rights in or to such Old Securities may be kept alive for a greater or lesser time and for any purpose the Division Chief and Counsel may deem necessary" Ex. OO, 164(c)).

8. Emphasis ours in this brief except as otherwise noted.

"* * * Until such Old Securities have been exchanged for New Bonds, all such securities as well as all rights in or to the same shall continue to be and constitute obligations of the Borrower for the full amount thereof and nothing in this resolution shall be deemed to limit the right of this Corporation to enforce or cause to be enforced full payment of principal and interest of such Old Securities as and when the Division Chief and Counsel shall deem it advisable to do so * * *" (Ex. OO, 164-165).

The resolution further provides that the borrower will annually levy and collect assessments sufficient to pay the principal and interest upon the old securities according to their tenor and effect during the time any of the old securities are held by or on behalf of the R. F. C., except as waived by the Division Chief (Ex. OO, 165(d)).

On February 11, 1935, the district passed a resolution for the refunding of its old securities. Paragraph 3 thereof (Ex. OO, 189) provides as follows:

"3. As provided for in said Corporation Resolution, the District hereby promises, covenants and agrees with said Reconstruction Finance Corporation to the effect that so long as any of said new bonds or any of the old securities pledged with or acquired by Corporation remain outstanding, said District will duly and fully fulfill, comply with and carry out all of the terms and conditions on its part to be fulfilled, complied with and carried out under the terms and conditions of said Corporation Resolution, and further that said District will at all times levy and collect sufficient assessments to pay all expenses of operating, maintaining and repairing its works, all sums necessary for payment of interest and principal on

> the bonds and any other indebtedness at any time owed by the District * * *" (Ex. OO, 189).

The foregoing resolutions are preliminary but carefully provide for keeping the old securities alive.

The formal agreements between the parties are found in the Record (Ex. OO) at pages 202, et seq. and 217 et seq. The first of these, dated August 14, 1935 (Ex. OO, 217) is one under which disbursement was made by the R. F. C. on October 4, 1935 (R. 344). Under this agreement the district agrees to bring about the participation of *all* the old securities in the refinancing plan (Ex. OO, 218). The R. F. C. agrees to make disbursement "for the purpose of acquiring any portion of the old securities" which may be available for refinancing (Ex. OO, 219). It is then provided as follows:

> "2. Until the Old Securities acquired and held by the Corporation by reason of or in connection with such disbursements, are exchanged for New Bonds issued by the District, or are otherwise refinanced as provided in the Resolution, they shall at all times continue to be and constitute obligations of the District for the full face amount thereof." (Ex. OO, 219.)

Paragraph 6 provides as follows:

> "6. During the time the Corporation holds any of the Old Securities and the same have not been refinanced by the issuance and delivery of New Bonds or as otherwise provided in the Resolution, the District will annually levy and collect taxes and assessments in sufficient amounts to pay, and will pay, the Corporation each year a sum that will yield to the Corporation four per cent upon the total amount of

> the disbursements made to or for the benefit of the District in acquiring such Old Securities, or rights or interest in or to the same; provided, that the Corporation can, during any such time, require the District to pay any larger sum not exceeding the amount due on said Old Securities according to the terms thereof, in which event the District will so levy, collect and pay such larger sum." (Ex. OO, 220.)

The agreement of September 14, 1935 (Ex. OO, 202 et seq.) is the formal agreement in which the R. F. C. agreed to purchase the refunding bonds of the district. It relates primarily to the refunding bonds except as follows:

> "* * * R. F. C. may, in its discretion, keep any part of said indebtedness alive, for the sole purpose of maintaining a parity between itself and the holders of indebtedness of said Borrower who have not agreed to enter into the refinancing scheme of said Borrower, or for any other purpose." (Ex. OO, 203.)

Pursuant to the above noted agreement of August 14, 1935, the R. F. C. wrote to the Federal Reserve Bank to purchase for its account bonds which had been deposited for refinancing (Ex. 10, R. 557). Formal bills of sale for $14,071,000 were executed to the R. F. C. (R. 344; Ex. 11, R. 574) in accordance with the form memorandum of sale attached to Exhibit 10 (R. 571). The balance of the bonds have been sold to the R. F. C. "over the counter" (R. 348). At the time of trial it held $14,702,000, or 90.802%. All bonds have been registered in the name of the R. F. C. as owner (R. 349). These bonds have been held by the Federal Reserve Bank subject to sole control of the R. F. C. (R. 349-350). No refunding bonds or

promissory notes have been issued by the Merced Irrigation District or delivered to the R. F. C. (R. 361).

The foregoing testimony was not denied. It is asserted however, that the contracts do not mean what they say in respect to keeping the old bonds alive. Testimony was also offered by appellants as to the correspondence and conduct of the parties which, so they allege, served to nullify the agreement that the old securities would remain uncancelled. Actually the testimony offered by appellants on this point did no such thing and furthermore it was rebutted by petitioner (R. 361-366, 385-398) and could not at most do more than to raise a conflict which the trial court resolved in favor of petitioner. Appellants say the evidence offered by them shows that the R. F. C. and the district have repeatedly acknowledged that the indebtedness of the district to the R. F. C. is the purchase price of the bonds, not the old bonds. This is not true. Nothing in the record justifies the assertion that the R. F. C. has waived its right to enforce the old bonds in full. It is true that in certain correspondence between employees of the district and the R. F. C. the transaction is sometimes spoken of as a "loan" and properly so (it was a *conditional* loan). Generally though, the letters referred to a "purchase" (Exs. 20 and 21, R. 652 et seq.). In some of the letters or documents written by employees of the R. F. C. the old bonds are loosely referred to as "collateral" or "security" and the money used to buy old bonds as an "advance".

But of course it is of no consequence what phraseology employees or third persons may use in attempting to describe this rather complicated transaction. The solemn

and official obligations of the two contracting parties, governmental agencies both, are set forth in their contract and are not to be nullified by collateral letters or documents of this type.

Nor do the books of the R. F. C. show any waiver of the old bonds. The items of principal indebtedness referred to by appellants on page 20 of their brief are those set forth in a questionnaire the form of which was submitted by the R. F. C. to the district. In the form the district is expressly instructed *"Do not include outstanding bonds of issues to be refinanced"* (R. 778). Contrary to the claim of appellants this is not an admission that the old bonds have been extinguished but an assertion that they are outstanding and are to be refinanced.

In sum, the evidence really showed without conflict that the contract of the parties was this:

The R. F. C. agreed to loan money to the district to refinance its bonded debt (*all* of its bonded debt) at $515.01 for each $1000 bond. The loan was subject to certain conditions one of which was that all old securities should be purchased and held by the R. F. C. at full value —in other words, kept alive and outstanding—until the R. F. C. was satisfied refinancing was complete. At that time the R. F. C. agreed to buy and accept refunding bonds subject to the contract of September 14, 1935 (Ex. OO, 202). Then and only then the old bonds were to be surrendered and cancelled.

The legal relationship of the parties is carefully defined not only as it is to be after a permanent status is reached, that is to say, after the refunding bonds are issued to the R. F. C. but also as it is to be during the "interim" or

"temporary" period when the transaction necessarily could not have reached its "permanent" or "final" form. In every controlling resolution and contract it is stipulated the old securities are to be kept alive pending completion of refinancing. And the payment of 4% to be made by the district on the money used by the R. F. C. to purchase bonds is clearly an "*interim*" payment for the use of new money put into an insolvent enterprise by a third party for the benefit of the debtor and its creditors.

Appellants seek to "label" the contract between the district and the R. F. C. as a "loan" and then to pour it into a legal "mould" from which it emerges with static legal attributes. This is what has been aptly called the "tyranny of labels". Judge McCormick in his opinion in *In re Lindsay-Strathmore Irr. Dist.*, 25 Fed. Sup. 988, at 991, answers it conclusively when he says that the mere use of such terms as "loan", "pledge" and "collateral security" does not "*ex proprio vigore*" determine what the "contractual relationship" is.

What appellants really assert is the right to determine for the R. F. C. when refinancing is complete. They not only seem to claim that the contracts were made for the benefit of themselves, but that they have the right to make the election for the R. F. C. as to when the "major part" of the old bonds have been refinanced.

C. The Bankruptcy Act Clearly Makes the R. F. C. a Creditor in the Full Face Amount of the Bonds Purchased.

Chapter IX of the Bankruptcy Act sets up the structure for composition of debts of public agencies and fixes the rights of the parties here. See recent cases of U. S. Supreme Court, as follows:

City Bank & Farmers Trust Co. v. Irving Trust Co., 299 U. S. 433, 57 S. Ct. 292, 81 L. Ed. 324,

holding Congress has the right to define the term "creditors" and the claims provable.

Schwartz v. Irving Trust Co., 299 U. S. 456, 57 S. Ct. 303, 81 L. Ed. 348;

Meadows v. Irving Trust Co., 299 U. S. 464, 57 S. Ct. 307, 81 L. Ed. 353;

Wright v. Union Central Life Ins. Co., 304 U. S. 502, 58 S. Ct. 1025, 82 L. Ed. 1490.

As these cases point out, Congress is authorized under the bankruptcy power to cover nothing less than the entire subject of the relations between an insolvent or nonpaying debtor and his creditors extending to his and their relief. If the English language means anything at all Congress intended the R. F. C. to be a creditor for the full amount of the old bonds. In fact this case and others similar in nature were doubtless before Congress when the act was passed.

Section 82 defines "creditor" as the "holder of a security or securities" and "any agency of the United States holding securities acquired pursuant to contract with any petitioner under this chapter shall be deemed a creditor in the amount of the full face value thereof". Also, subparagraph (j) of Section 83 provides that the partial completion or execution of any plan of composition by the exchange of new evidences of indebtedness, whether such partial completion occurred before or after the filing of the petition, shall not be construed as limiting or prohibiting the effect of the act, and the

"written consent of the holders of any securities outstanding as the result of any such partial completion

> or execution of any plan of composition shall be included as consenting creditors to such plan of composition in determining the percentage of securities affected by such plan of composition."

In the brief of appellant Florence Moore (p. 30) it is urged that Section 82 means simply that the R. F. C. is entitled to enforce the old bonds as collateral to such extent as may be necessary to return the amount of its advance. If that be true, Section 82 adds nothing to the law as that would be clearly the right of any pledgee. Furthermore, if the R. F. C. is entitled to enforce the old bonds it would get ninety cents on every dollar collected by the district until such time as its advance was repaid. This is but another way of saying that the district "cannot pay its debts as they mature" because obviously if the old bonds are to be serviced, default and collapse would be inevitable long before the amount of the advance could be returned.

It is said we contend for a retrospective interpretation of Section 82 but this is premised upon the erroneous assumption that the old bonds were extinguished and cancelled before Section 82 was enacted. The contrary has been shown to be the case.

The same brief passes Section 83(j) with the statement it is limited to cases where refunding bonds have been issued but here appellant misses the plain intent of the statute. If partial completion of a plan and the delivery of refunding bonds under Section 83(j) does not limit the creditor's claim, for a stronger reason it is not limited where the old bonds are still outstanding.

The cases decided under Sections 81 to 84 as to the status of the R. F. C. in these reorganization proceedings

are in full accord with the foregoing statements and are clear, forceful and convincing. See, in addition to *Luehrmann v. Drainage Dist. No. 7* (June 1939, 8th Circuit), 104 Fed. (2d) 696 (certiorari denied November 6, 1939), which is really conclusive, the following:

In re Drainage Dist. No. 7, 25 Fed. Sup. 372;

In re Merced Irr. Dist., 25 Fed. Sup. 981;

In re Lindsay-Strathmore Irr. Dist., 25 Fed. Sup. 988;

In re Corcoran Irr. Dist., 27 Fed. Sup. 322.

D. Aside From the Clear Provisions of the Bankruptcy Act, Principles of Law so Long Established and Adhered to as to be Fundamental, Make the R. F. C. a Creditor for the Full Amount of the Old Bonds Held by it, if as Here, that be the Intention of the Parties.

Prior to the enactment of Chapter IX the question now under consideration has repeatedly arisen in reorganization cases. There is almost always a small minority of dissenters, as here, and reorganization agencies found it necessary to acquire outstanding securities and hold them at their full face value so as to assure equality among all holders. A long line of cases upholds such practice. We refer to but a few of such cases where the parties intend the obligations to remain outstanding:

Barry v. Mo. K. & T. Railway Company, 34 Fed. 829, at p. 832:

"*It was competent for the railway company, in carrying out its scheme of refunding, to agree with the holders of income bonds, coupons or certificates that, upon their exchange of their securities for new bonds, those surrendered should not be deemed paid, but should be kept alive to protect them against any enlarged claims of non-assenting holders; and, if such*

an agreement was made, the surrendered securities are to be regarded as held in trust by the trust company for the benefit of those who surrendered them. Ordinarily such an agreement or some other arrangement for the protection of those who surrendered securities, having a prior lien for securities secured by a junior mortgage, is one of the features of the refunding schemes of corporations."

The above case (*Barry v. Mo. K. & T. Railway Company*) is based on *Ketchum v. Duncan*, 96 U. S. 659, 24 L. Ed., 868, in which it appeared that Alexander Duncan held coupons due in May and November, 1874, from bonds issued by Mobile & Ohio Railroad. He brought suit to foreclose the lien thereof. Other bondholders also sued to foreclose claiming that the coupons held by Duncan had been cancelled by payment. The court held that the facts showed an intent to purchase the coupons and not to cancel them. It says on page 871 (of Law Ed.):

> *"Such a sale would have worked no injury to the bond holders of which they could complain. They are in no worse condition now than they would have been in the case supposed."*

And concludes, page 873:

> "In view of this, it cannot be maintained, either that the coupons of May and November, transferred to Duncan, Sherman & Co., were paid, or that, in obedience to any rule of law or equity, the net earnings of the road should have been applied in payment of them. They are, therefore, existing liabilities of the railroad company, and protected by the first mortgage."

Claflin v. South Carolina Railroad Company, 8 F. 118, was a suit in equity by bondholders of the South Carolina Railroad to foreclose a mortgage subject to the lien of prior encumbrances. Certain bonds had come into the hands of the issuing company and had afterwards been resold. The court says, page 124:

> "*As against other bondholders secured by the same mortgage, I cannot believe there is a doubt of the power of the company to put out and keep out the entire issue up to the time the bonds become due. The contract with the individual bondholder is no more than that he shall have his due proportion of the security the mortgage on its face implies.*"

In *Slupsky v. Westinghouse,* 78 Fed. (2d) 13, the court says at page 16:

> "Whether the acquisition of bonds by the corporation which issues them amounts to payment and cancellation, or to a purchase, depends upon the intention of the parties."

In *Burlington City Loan & T. Co. v. Princeton Lighting Co.,* 72 N. J. Eq. 891, 67 Atl. 1019 (Nov. 18, 1907), it is held:

Where an agreement for the merger of corporations provides for the exchange of the whole of an outstanding issue of bonds for new bonds of the consolidated company by depositing them with a trustee, *and the deposited bonds are held by the trustee uncancelled, and the agreement is not consummated owing to the failure of some of the old bondholders to assent,* the question whether the bonds actually deposited are to be held as additional security for the benefit of those depositing them and taking new

bonds in exchange, or for the benefit of all holders of the new bonds, depends on the intention of the parties and the facts of the case. The court says:

> "* * * Three views suggest themselves to us as possible: (1) the deposited bonds may be held for the benefit of all the new Princeton bondholders pending the exchange of the whole issue; (2) they may be held as collateral security to the new bonds taken in exchange and for the benefit of the depositing bondholders only; or (3) *they may be treated as satisfied for the benefit of those who have refused their assent to the scheme. The last seems to us inequitable, for the reason that it allows nonassenting bondholders to profit by a transaction which they have in effect opposed. All that they are equitably entitled to is such a proportion of the mortgage security as their bonds bear to the whole issue. Barry v. M. K. & T. Railway Co.* (C. C.), 34 Fed. 829. This allows them all they would have but for the merger agreement, and merely denies them an increased security due to the efforts of others. *Equity does not allow them to gather the fruit after others have shaken the tree.* While it may fairly be argued as some of the cases suggest that the depositing bondholders by the exchange of bonds evince an intention to give up the lien of their old bonds, it by no means follows that they intend to give up that lien for the benefit of those who refuse to cooperate with them. It is far more reasonable to assume that, if they give it up at all, it is for the benefit of all the new bondholders, who, in return, allow them to share in the security of the new bonds."

In *Mowry v. Farmers' Loan & Trust Co.,* 76 Fed. 38, the court says, page 43 et seq.:

> "* * * The scheme of reorganization here involved is manifested by the agreement between the assenting

bondholders and stockholders and their trustee or committee, and by the concurring act of the railroad company, manifested by the mortgage issued by it to effectuate the scheme. It was clearly expected that all the bondholders under prior mortgages and the stockholders would unite in this plan of reorganization; and yet, *recognizing what oftentimes, and perhaps generally, occurs in the reorganization of railways, that some of the bonds might not be found, or that some holders would not assent to the scheme of reorganization, provision would seem to have been made to guard against just such a contingency, and to prevent the inequitable result which will follow if nonassenting bondholders should, by means of and through the reorganization to which they would not agree, obtain, with respect to the nonassenting bonds, a decided and inequitable advantage over assenting bondholders, who theretofore stood with them upon an equal plane.* * * * The legal effect of the transaction was that the assenting bondholder received the consolidated bond and held the prior bond, keeping both alive until the satisfaction of prior mortgages * * * *as observed by Judge Wallace in Barry v. Railway Co.*, 34 Fed. 829-833, *when it became necessary to enforce the mortgage securing the nonassenting bonds, 'complete equity is done them if they are awarded the same share of the proceeds of the property which they would have received if no bonds had been surrendered'.*"

In *American Brake Shoe & Foundry Co. v. New York Rys. Co.*, 277 Fed. 261 (1921), it was held, following the *Barry* case, that a purchase by a corporation of its own bonds with cash in its treasury does not extinguish the same where it was the manifest intention they should be kept alive. Suit was brought to foreclose the first mort-

gage. There were one million dollars of first mortgage bonds pledged with plaintiff as collateral security for a loan to the railroad company. It appears that these bonds were purchased at an average cost of not exceeding 80% by the debtor and pledged as collateral security for the loan of $1,200,000. Later this loan was reduced to $400,000. Plaintiff did not claim a lien upon the bonds but insisted that they are still outstanding. Other defendants claimed they were extinguished. Court held it was the clear intention of the railway company to keep the bonds alive. The court says (p. 281):

> "Such a course is both lawful and proper. It is always a question of intention."

At page 282 the court says:

> "There are bonds thus outstanding to the extent of $18,019,948.24. But a bond cannot be outstanding and yet not outstanding. It is either dead or alive. If alive, it is entitled to share in the proceeds of the foreclosure sale. The situation merely is that plaintiff owns seventeen-eighteenths, in round numbers, and Railways Company owns one-eighteenth, in round numbers, subject to the $400,000 pledge. All the mortgaged property is security for the whole eighteen-eighteenths. Hence plaintiff will be entitled to seventeen-eighteenths and Railways Company (which, in the circumstances, means its creditors) to one-eighteenth, in round numbers, of such sum produced by foreclosure sale, as ultimately may be held to be applicable to the payment of the mortgage debt.
>
> After, therefore, the $400,000 shall have been paid, the proportionate balance, if any, will go to the Railways Company, and will be applicable to the payment of general creditors' claims as between this plaintiff and defendant Railways Company."

In *Missouri K. & T. R. Co. v. Union Trust Co.*, 156 N. Y. 592, 51 N. E. 309 (1898), we find the following pertinent language at page 599:

> "* * * In other words, as held in *Barry v. M. K. & T. Ry. Co.* (34 Fed. Rep. 829), purchased bonds must, for many purposes, and in this case for the purpose of the sinking fund clause, be considered as still unpaid, so far as the rights of the outstanding bondholders are concerned."

In *Fidelity & Columbia Trust Co. v. Louisville Ry. Co.*, 258 Ky. 817, 81 S. W. (2d) 896 (1935), it was held:

> Purchase of its bonds by railroad from trust company before maturity as extended and pledge of them as security for payment of purchase price pursuant to refinancing plan expressly providing that railroad may after payment of purchase price reissue such bonds from time to time to provide necessary funds would not constitute an extinguishment of such bonds.

The refinancing plan provided that the railroad would purchase its first mortgage bonds and that it would pay for them by executing a note and pledging the bonds to secure the payment of the purchase money notes. The court says, at page 899:

> "The rule recognized without exception by American courts is that a corporation may purchase its own bonds and reissue them where there is a manifest intention to keep them alive. In other words, the purchase by a corporation of its own bonds under such conditions does not operate as an extinguishment of the debt. The English rule was contrary to the American rule until changed by an act of Parliament in 1907."

The court then quotes approvingly from the *Barry* case and follows with citations of the *American Brake Shoe and Foundry Co.* case, *Claflin* case, *Westinghouse Electric Manufacturing Co.* case and a number of others and concludes as follows:

> "The text-writers, basing their text on these cases, have uniformly stated the rule to be that the purchase by a corporation of its own bonds before maturity with a plainly evidenced intention to keep them alive and reissue them does not operate as an extinguishment of such bonds. Thompson on Corporations (3d Ed.) Vol. 3, Sec. 2401, p. 1105; Cook on Corporations (6th Ed.) Vol. 3, Sec. 762, p. 2579; Fletcher on Corporations, Revised Edition, (Vol. 6) Sec. 2729, p. 589; Jones on Corporate Bonds and Mortgages, Sec. 325; 14 A Corpus Juris, pp. 644 and 648. We conclude that the purchase by the Louisville Railway Company of its first mortgage bonds under the proposed refinancing plan, after the maturity of the bonds has been extended, will not extinguish the bonds."

In *John Wanamaker New York, Inc. v. Comfort, et al.*, 53 Fed. (2d) 751 (1931), the court says at pages 753-754:

> "* * * Another case very much in point is Mowry v. Farmers' Loan & Trust Co. (C. C. A.) 76 F. 38. In that case it appeared that the reorganization agreement of a railroad provided for the issuance and exchange of new securities for old, the deposited bonds to be held by the trustee under the mortgage as additional security for the new bonds. It was held that the bonds deposited were not extinguished and the lien securing them was not waived. To the same effect are the cases of Barry v. Mo. K. & T. Co. (C. C.) 34 F. 829; N. Y. Security & Trust Co. v. Louisville, E. & St. L. Consol. R. Co. (C. C.) 102 F. 382; and the

U. S. v. Grover (D. C.) 227 F. 181, in all of which it was held that the intention of the parties must govern and that new issues of bonds were valid and protected by the lien of the original mortgage."

Appellants have nothing to say about the long line of authorities just cited,[9] except that in the brief of appellant Florence Moore (p. 31) the case of *Barry v. Mo. etc. R. Co.*, 34 Fed. 829, is referred to lightly with the statement that—"there is some authority (although it is not generally accepted)." The truth is that *Barry v. Mo. etc. R. Co.*, is a leading case cited with approval in practically all of the cases just listed, right up to and including the very recent decisions there noted. Furthermore, the rule expressed in that case is said in *Fidelity & Trust Co. v. Louisville etc. R. Co.*, 258 Ky. 817, 81 S. W. (2d) 896 (1935) *supra*, to be the uniform rule approved by the text writers.

And finally: what the *Barry* case held in effect was *that dissenting security holders are not entitled to any more than they would have received if consenting security holders had not surrendered securities pursuant to a plan of reorganization. In other words, the dissenting bondholders here are required to establish their rights on the basis of a $16,000,000 bond issue.*

E. Further Answer to Appellants' Contentions Herein.

1. Appellants say if there was a "loan" the old bonds must be held as a "pledge" or "collateral security" and can only be enforced up to the amount expended by the R. F. C.

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9. Nor do they attempt to meet the holding in *Luehrmann v. Drainage Dist. No. 7*, 104 F.(2d) 696 (certiorari denied Nov. 6, 1939), which is directly in point on the status of the R. F. C.

And they say that the resolution of November 14, 1934 (Ex. OO, 165), provides that if the district should, before delivery of the new bonds, repay the R. F. C. the amount expended, the obligation would be terminated. Hence they argue, the district owes only $7,570,871.60 to the R. F. C. From this they conclude that the R. F. C. is a creditor only to the extent of $7,570,871.60 and that the district can pay its debts as they mature.

There are many answers to this, namely: (a) The authorities cited in paragraph *D* above are to the contrary, (b) the contract relating to the purchase of the old bonds is the agreement of August 14, 1935 (Ex. OO, 217), and not the resolution above referred to, (c) the claim assumes that the R. F. C. holds the demand note of the district for the money used to purchase the old bonds, to-wit $7,570,871.60, and that it holds the old bonds as security for this demand note. Of course no note was given by the district and it did not agree to repay this money, (d) but in any view the district is unable to "pay its debts as they mature". It does not have $7,570,871.60; could not raise such a sum of money in cash over a period of years; obviously could not sell refunding bonds for that sum of money with dissenters' bonds outstanding, and any attempt to enforce payment of that much money in cash or to enforce the old bonds alleged to be held as security up to the amount of such demand would unquestionably result in default and collapse.

2. Appellants seem to argue that the R. F. C. could be forced to accept refunding bonds to the extent of its alleged advance. Not a syllable in the contracts justifies

such claim. It is of course quite a different thing to accept refunding bonds when all of the old bonds have been turned in and to accept refunding bonds when there are approximately two million dollars outstanding on a former issue. No sane banker or underwriter would accept refunding bonds on such basis.

3. The fact that the district paid with its own funds certain money to the consenting bondholders at the time they sold to the R. F. C. proves nothing. The purchase of the bonds by the R. F. C. was admittedly in the interest of the district. It was a step in refinancing and afforded sufficient consideration for the district to expend money in aid thereof.

4. The setting up of the reserve funds and the power allocation is merely a step in the carrying out of the agreement for the purchase of refunding bonds pursuant to the agreement of September 16, 1935 (Ex. OO, 202). If refinancing is never consummated and the R. F. C. does not take the refunding bonds obviously the set up of the reserve funds and the allocation of the power is nullified.

It is argued that the R. F. C. is in a different class of creditors because of the allocation of power revenue and that therefore it is the holder of a claim for the payment of which specific property or revenues are pledged; that accordingly under 83b it constitutes a separate class. If this were true and its preference was disregarded in classifying creditors it is a point of which the R. F. C. alone may take advantage. It is not error to the injury of appellants.

5. It is claimed, that the R. F. C. did not file a claim or allege ownership. The petition alleges that the R. F. C.

is the owner of the bonds and, as such owner, consented to the plan of composition attached to the petition (R. 17, 32). The evidence proved the allegations and the court so found. Under these circumstances, it is far-fetched to argue that the proceeding must fail because no alleged claim is on file. Of course, the record is replete with the claim of the R. F. C. (see Ex. 16, R. 644, acceptance of the plan) and furthermore, the act itself expressly provides (Sec. 83d) that creditors whose claims are "admitted by the petitioner or allowed by the Judge" are to be counted in making up the required percentage of creditors.

6. The pledge argument has been answered.

7. It is claimed that neither the R. F. C. nor the district had authority other than to make a loan. This is wrong on all counts. (a) The R. F. C. is authorized to consummate a loan through the purchase of securities (Sec. 36, Emergency Farm Mortgage Act, Title 43, Sec. 403, U. S. C.); (b) the district is authorized to make contracts with the R. F. C. relating to refinancing (Cal. Stats. 1935, Chap. 615, Secs. 1 and 11) and this of course includes necessary and incidental power to make the refinancing effectual; (c) if the contract of either agency were *ultra vires* this is an objection appellants cannot raise.

> *Union Nat. Bank v. Matthews,* 98 U. S. 621, 25 L. Ed. 188, 190;
>
> *McCann v. Childrens Home,* 176 Cal. 359, 364.

The Supreme Court has recently reasserted the rule that a private individual may not invoke judicial power to determine the validity of executive or legislative action

unless he sustains direct injury not common to the public. See,

> *Ex Parte Levitt,* 302 U. S. 633, 58 S. Ct. 1, 82 L. Ed. 493 (Appt. Justice Black);
>
> *Alabama Power Co. v. Ickes,* 302 U. S. 464, 58 S. Ct. 300, 82 L. Ed. 374 (Jan. 3, 1938—PWA grants).

Appellants were not injured by the R. F. C. purchase. Anyone could have purchased. In truth, by any test, appellants were benefited. Furthermore, it would not follow if the parties acted without authority of law that the court would make a new and different contract for them. If the action was void it might follow that the old bondholders would have some remedies but not that the transaction would be converted into something not intended by the parties.

8. It is argued that no statute permits debts that have been extinguished to be treated as still existing. This has been answered. They are *not* extinguished.

9. It is claimed that the plan has been fully executed out of court. This, too, has been answered. *In re West Palm Beach,* 96 Fed. (2d) 85, there was a completed plan of reorganization, cancellation of the old bonds, and delivery of the refunding bonds. Furthermore, subsection (j) of Section 83 of the Bankruptcy Act was undoubtedly added to change the rule in the *West Palm Beach* case.

10. It is argued that the R. F. C. and the district are bound by the acceptance by the R. F. C. of the plan in the state court under California Stats. 1937, Chap. 24, Sec. 19. The exact point appellants make is not clear but in any event Section 19 clearly is not applicable because

the proceeding in the state court was not dismissed nor was there a declaration of invalidity. Section 19 by its terms is only applicable if the action is dismissed because the plan is found to be unfair or if the act is otherwise found to be invalid. Its purpose is merely to protect against the release of consenting creditors in such contingencies. It has no bearing here.

ANSWER TO SECOND PROPOSITION: "PETITIONER IS BARRED * * * BY REASON OF ITS LACK OF GOOD FAITH AND CONSTRUCTIVE FRAUD."

1. The District's Hands are Clean.

It would be interesting to debate with appellants whether if the district in truth had "unclean hands" it would be barred from relief regardless of the merits of the plan, the interests of creditors and public repose. "Good faith" is probably used in the Bankruptcy Act in the sense of "feasibility" and ability to carry out (see, *Tenn. Pub. Co. v. American Nat. Bank,* 299 U. S. 18, 57 S. Ct. 85, 81 L. Ed. 13, at 15). Reorganizations where necessary are in the interest of the creditors as well as the debtor (see *Chicago Title & T. Co. v. Forty One Thirty Six Wilcox Bld. Corp.,* 302 U. S. 120, 58 S. Ct. 125, 82 L. Ed. 147, per Justice Cardozo, dissenting opinion, p. 154; *Compare Getz v. Edinburg etc. School iDst.,* 101 Fed. (2d) 734; *Radio-Keith-Orpheum Corporation,* 106 Fed. (2d) 22). Sec-83e provides that the plan must be confirmed if certain things are shown and "clean hands" are not one of them.

But we pass. this question because the record is clear to the point of demonstration, that the District at all

times has acted with the utmost fairness and good faith. The assertion to the contrary is not only wholly unsupported by any meritorious evidence but is based on the flimsiest of technical reasoning by those to whom the utmost courtesy and cooperation have been shown in respect to all records and information in the custody of the district. They have had the benefit of the services of district employees in the preparation of exhibits, and all of the investigations, studies by engineers and other experts, and legal and other expenses of the Bondholders' Committee were paid by the district (R. 371-372), including the cost of the Benedict report (Ex. 35).

The charge now made by appellants was really for the first time made in affidavits upon motion for new trial which the court denied "in toto" after "re-examination of the entire record" (R. 267) including the affidavits. Petitioner's affidavits, which furnish a complete answer, are found in R. 254-265. Note particularly on the charge of bad faith, the affidavit of H. P. Sargent, secretary of the district (R. 257-261). On this point, note also as merely illustrative, Exhibit 37 (R. 736-754, letter from bondholders' committee to bondholders, dated December 15, 1933, and signed by a number of the appellants here) which shows that the committee was advised of the financial status of the district to the minutest detail.

The district's books and record of accounts were continuously in the public eye from 1931 to date being used by bondholders and their representatives, by various mortgagors and property owners who had investments in the district, by officials of the California Districts Securities Commission, a public agency which from time to

time made detailed investigations and reports on the district (Exs. 29-33A, R. 678-732) and through the medium of financial statements publicly rendered by the district from time to time (see Ex. X, R. 827 et seq.—annual statements of district 1931-1937 inclusive).

There was no fraud or misrepresentation.

2. Petitioner Did Not Divert $717,932.50 of Trust Funds.

Appellants would have it appear that the district in effect "embezzled" money belonging to bondholders. The fact is, that all money taken in by the district has been meticulously accounted for, and if there is any money which went into the general fund which should have gone into the bond fund it is now in the treasury of the district and applicable to the satisfaction of the bondholders' claims in the event that the plan of composition fails. What appellants are really objecting to is simply a matter of bookkeeping, that is to say, whether certain money should have gone into the bond fund instead of the general fund. If, however, it was bond fund money, *that and a great deal more than the amount alleged to have been diverted, is in the district treasury for the satisfaction of any bondholders' legal right.*

It is not charged that the district in the years following the default spent any more than was necessary for operation and maintenance of the district. It is not charged that it was extravagant. On the contrary the evidence established that betterments and very necessary improvements have been deferred (R. 513). Any property acquired by the district, as pointed out in *Provident Land Corp. v. Zumwalt,* 12 Cal. (2d) 365 at 376 (85 P. (2d) 116),

is held in trust for all the purposes of the act, including operation and maintenance.

The district has not spent one unnecessary cent and what it did spend in operating and maintaining the district was in the interest of bondholders. Furthermore, every dollar collected either by way of assessment or power revenue or on delinquencies or sale of land and not expended for operation is now in the treasury to be put in whatever fund the court deems proper and disbursed as required by law if the plan of composition fails.

The $717,932.50 is really $320,272.93 (R. 413-414). Each year from 1922-23 to 1931-32 inclusive, after bond service was satisfied, the balances of the bond fund levy (delinquency collections, etc.) were placed in the general fund as expressly authorized by law (Sec. 67a, Irrigation District Act, in effect when bonds were issued (Cal. Stats. 1917, p. 769), reading as follows:

> "Whenever an object for which money has been specifically provided by assessment or by bond issue has been accomplished and any money provided therefor remains unexpended, the same shall in the discretion of the board of directors be transferred to the general fund and thereafter be available for any of the purposes of this act."

This accounts for all except $320,272.93.

The $320,272.93 represents collections of delinquencies from time to time on the 1932-33 tax levy after 1933 and up to the present. The levy was to service bond obligations due January 1, 1933 and July 1, 1933. The assessment went 62% delinquent (R. 402) and there have been no levies for bond service since (R. 403). The district

has met all obligations due to July 1, 1933 (R. 400-404) so in considering the $320,272.93 we are only concerned with the bond obligations due July 1, 1933.

Note the following: (a) The first refunding plan which the bondholders' committee (made up in part of appellants) and the district tentatively approved and endeavored to carry out, and which, from the standpoint of good faith is important, expressly provided that "no payment is to be made upon the coupons which were due July 1, 1933 and that the payment of the bonds and coupons which were due January 1, 1933 is to constitute in effect full payment of interest falling due during the entire year" (R. 748). (b) The plan submitted in the first bankruptcy action, and under which the district operated from April 1935 until reversal by this court in April 1937 (R. 518) contemplated no payment due on the July 1, 1933 coupons. $515.01 was, and is, a flat amount for the bond, including all coupons due July 1, 1933 and subsequently. After the Supreme Court denied mandate in the first bankruptcy case in October 1937 (R. 519), the district filed in the state court; the same plan was involved there and Section 5 (Cal. Stats. 1937, Chap. 24) again put the plan temporarily into effect until this present proceeding was filed in June, 1938 (R. 519). Hence during the period in question the action of the district in placing delinquency collections on the 1932-33 levy in the bond fund has had the express or implied sanction of the bondholders' committee or the court (Ex. 16, R. 644) and the district has operated under the jurisdiction of the Districts Securities Commission.

So it all comes to this: $320,272.93 which was collected on delinquencies on the 1932-33 levy during the years succeeding 1933, was put in the general fund. It has been replaced many times over by general fund money now in the treasury and no unnecessary expenditures have been made. All of the January 1, 1933, coupons have been paid. If the plan is confirmed by the court appellants receive $515.01 in lieu of each $1000.00 bond, including the coupons due January 1, 1933, and subsequently. If the plan is not approved and the district reverts to the old bond issue, $320,272.93 is available in the district treasury for transfer to the bond fund where it can be used to service the coupons due July 1, 1933. Money has not been diverted in the sense that it has been lost to the bondholders if they can prove any right to it.

And finally, if the district reverts to the old bond issue the R. F. C. obviously holds roughly 91% of the coupons due July 1, 1933, and it also holds most of the matured bonds (App's. Brief p. 60), so that at most all of appellants taken together would be lucky to establish a claim to $32,000 of the money and probably not that much since the R. F. C., in general, holds the coupons having the first priority.

3. Petitioner Has Not Defrauded its Creditors.

It is charged that the alleged diversion of bond funds had the "necessary effect" of "driving down" the market price of the bonds and thereby stampeding bondholders into accepting the plan now sought to be enforced. (Brief p. 45).

A more distorted statement would be difficult to imagine. The granting of the R. F. C. loan in November, 1934 *raised* the price of bonds from eighteen cents to approximately fifty cents on the dollar (R. 500). The alleged collections were for the most part long after that date.

The alleged refusal to levy taxes for bond service during 1933-34-35-36-37-38 was not a refusal at all, but pursuant to law (Sec. 11 of the Districts Securities Commission Act, Cal. Stats. 1933, Chap. 60, 1935, Chap. 36 and 1937, p. 491). The levies were all duly approved by a state agency (Exs. 29-33A, R. 678-732). No attempt has been made by the bondholders to challenge the legality, constitutionality or equity of that law.

It is said (Appellants' Brief p. 46) that the district gets cheap water, and an attempt is made to compare this with other districts. Comparison of cost per acre feet of water in various irrigation districts is absolutely impossible with any degree of accuracy; each district has its individual problem of water distribution which affects cost; the duty of water in various irrigation districts differs; canal losses from diversion point, policy as to point of delivery, and type of service, are a few of the factors which make it impossible to have any degree of accuracy in comparison of cost of water delivered to the land. A further obvious unfairness in the comparison of water cost is that the cost in the Merced District under the emergency tax rate under Section 11, is compared with costs to lands in Banta-Carbona, Lindsay-Strathmore and Turlock Districts for the year 1929, not under Section 11 but under regular operation and maintenance and bond service assessments.

Appellants' statement of testimony on tax delinquencies (Brief pp. 46-47) entirely omits to notice the fact that from the tax rolls in each of the years noted, particularly 1936, there was deducted a large amount of delinquent taxes through the district's taking deed to the property (Ex. 28, R. 677). The average delinquency for the three years as of November 1, 1938, therefore, should be 7.5% not 1 1/13% (Ex. 25, R. 668).

4. The District Did Not Misrepresent its Financial Condition.

In support of their claim that the district misrepresented its financial condition, appellants offer mere fragments of the testimony giving it a garbled effect. The exhibits of Mr. Neel, the district controller, taken together with the financial statements (Exs. 23, 24, 25, 26, 27, 28, R. 662-678) present not only a clear picture of the district's financial status but answer every pertinent question anyone interested in the district would care to ask. They are really a very beautiful presentation from an accounting point of view, and we respectfully ask the court to examine them as a whole.

These exhibits were prepared in advance of trial and submitted to counsel at the start of the case so as to enable them to prepare for cross-examination or to ask for additional data. Furthermore, Mr. Neel prepared other exhibits for them at their request and worked with them, both in and out of court, so that a complete and accurate picture of the district's finances could be presented to the court.

A very unfair attempt is now being made to distort Mr. Neel's testimony and exhibits. A specific examina-

tion of these points will show that they relate not to substantial or meritorious matters but to purely technical matters relating to bookkeeping not in any sense connected with the merits of the case. In essence, appellants are asking that the plan be rejected because they say they do not agree with Mr. Neel on questions of bookkeeping concerning which doctors of accounting (C. P. A.'s) are at issue (R. 254—affidavit of Charles A. Lumbard, C. P. A.).

A. Petitioner Did Not Overstate its Liabilities.

The $824,684 paid as interest to the R. F. C. was carried by Mr. Neel on his books as an interest expense account (R. 425), in the nature of a refinancing charge. Of course if the plan fails it should probably be credited against the interest due on the old bonds held by the R. F. C. and Mr. Neel properly showed it as such a credit when he cast up the district tax rate in the event that the old bonds were serviced (R. 401, Ex. 22, R. 661). The fact of such interest payments appears over and over again in the evidence (R. 369, 425, Ex. E, R. 764). So there was no concealment or distortion of the account—merely a dispute as to bookkeeping entry.

$168,582 paid as interest to depositing bondholders was properly charged as a refinancing expense by Mr. Neel (R. 368, 369, 763, 865). There was of course no concealment whatever as to the payment itself (R. 763-764).

The $129,100 item (interest accruing on registered coupons and bonds) should be credited on the bonds if the $824,684 is credited, and not otherwise. It therefore falls in the $824,684 item, *supra*.

Exhibit 26 is said to overstate the bond principal liability by $387,000; in other words, the district is said to represent it had a total principal liability of $16,578,-000 notwithstanding the fact that the record *from the filing of the petition constantly* to the end of the case shows that the amount of principal bond liability was conceded by everybody to be $16,190,000 (R. 10). Furthermore, reference to the affidavit of Charles Lumbard, C. P. A. specializing in governmental accounting (R. 254-256) will show that the $387,000 was an internal item and correctly set up in Exhibit 26 (see also R. 520). Mr. Lumbard was the referee appointed by the court in *Morris v. Gibson,* 96 Cal. App. Dec. 347, 87 Pac. (2d) 37, 41, and his report was the basis of the decision in that case.

B. Petitioner Did Not Understate its Assets.

Very properly Exhibit 26 (speaking as of November 1, 1938) did not include as an asset the assessment levy of approximately $340,000 made for the year 1938-39. If so, it would have been proper to include the estimated expenditures for 1939 against the assessment (See affidavits of Mr. Neel and Mr. Sargent, (R. 257 to 265)). The facts relating to this assessment levy, as in all other questioned items, were clearly in the record.

Whether the amounts expended to purchase Crocker-Huffman water rights, to-wit, approximately $840,000 should appear as an asset is a question. Bookkeepers will differ as to whether such expenditures should be capitalized or are to be considered as a tax equalization between taxpayers under the old Crocker-Huffman system and new

lands included in the district and therefore an operating charge. The facts are all in the record (R. 511).

C and *D* have already been answered in *A* and *B*. We might again point out, however, as shown at p. 59 et seq. of this brief, excess of assets over liabilities does not prove ability to pay. Conceding everything argued here to appellants and a surplus of assets over liabilities, nothing is established on ability to pay.

Appellants charge (Brief p. 55) that petitioner maintained books and records on two separate theories of its liabilities to the R. F. C. This is not true. The district has consistently carried the old bond issue as a liability (Ex. 26, R. 669; Ex. I., R. 766). The R. F. C. submitted certain form reports for the district to fill in (Ex. J, R. 774, and Ex. K, R. 784). These forms do not purport to show the assets and liabilities of the district as reflected by the district books. The form expressly provided "Do not include outstanding bonds of issues to be refinanced" (R. 778, 788).

Appellants say (Brief p. 55) that "The existence of these reports and balance sheets was discovered by appellant's counsel on an inspection of petitioner's records just prior to trial under court order" (R. 143). The district voluntarily stipulated that the district's files could be inspected (R. 143). There was no coercion. If they were not inspected long before it was counsel's own negligence in not asking for it.

This case substantially had been tried twice before—once before Judge Cosgrove in the Federal court at Fresno and again before the Superior court at Merced. Before and during those trials appellants were given

whatever information they asked for on every occasion including all the records of the district that they wished to inspect. There is not even an intimation in the record of this trial that appellants were not given full access to the district's records at all times during the former trials and it is a fact that the district staff has been kept busy serving their demands. The present contention is pure after-thought conceived since the third trial and wholly unfounded on reality.

ANSWER TO THIRD PROPOSITION: "PETITIONER HEREIN IS NOT 'INSOLVENT OR UNABLE TO MEET ITS DEBTS AS THEY MATURE.'"

Appellants assume hereunder that the old bonds purchased by the R. F. C. are no longer liabilities.

So long as the old bonds are outstanding and enforceable according to their tenor the district cannot possibly "pay its debts as they mature" and appellants make no serious effort to show the contrary.

But it is argued that if the old bonds held by the R. F. C. are no longer obligations, the liabilities of the district are limited to the bonds of the dissenters and the amount paid by the R. F. C. for the old bonds. Even that would not prove that the district could pay its debts as they mature.

According to appellants the district owes the R. F. C. "only" $7,570,871.60. Assuming the truth of that how is it to pay $7,570,871.60 to the R. F. C.? It cannot require the R. F. C. to accept refunding bonds for that amount and it cannot require the R. F. C. to postpone indefinitely the repayment of this huge sum of money. Pre-

sumably, if appellants' theory is correct, the R. F. C. at any time can demand payment of the entire sum and if the district defaulted, which of course it would have to do, no attempt to levy or collect assessments for the payment of this huge sum would be helpful. On any theory, the district is unable to "pay its debts as they mature."

ANSWER TO FOURTH PROPOSITION: "THE PLAN OF COMPOSITION IS NOT FAIR, EQUITABLE OR FOR THE BEST INTERESTS OF THE CREDITORS AND IT IS DISCRIMINATORY."

Luehrmann v. Drainage Dist. No. 7, 104 Fed. (2d) 696:

On November 6, 1939, the Supreme Court denied certiorari in the above captioned case and the decision is now final (denied under name of *Haverstick v. Drainage Dist. No. 7*—citation not yet available). A reading of the opinion (a composition proceeding under Chapter IX) will show that practically every issue before the court in this case is passed on favorably to petitioner, including the insolvency of the district, the fairness of the plan, and the status of the R. F. C. It is direct authority for the district with respect to all of these issues and many collateral points raised by appellants. We shall not review the case in detail but respectfully ask the court to read it in full as it will conclusively eliminate most of appellants' contentions not only on the Fourth Proposition but many others.

It is highly significant that certiorari in the *Luehrmann* case was denied the same day the court decided *Case v. Los Angeles Lumber Products Company, Ltd.*, next to be reviewed. Probably the denial of certiorari is a sufficient ruling that an offer of "composition" of the debts of a

public agency is not to be judged with respect to the fairness of the plan by the same principles which control reorganizations of corporations under Sec. 77(b). Nevertheless, because of the danger of misconstruing the effect of the decision in *Case v. Los Angeles Lumber Products Company, Ltd.,* we shall devote some space to its review and shall show that even if petitioner is required to meet the standards of that case it has done so by every test.

Case v. Los Angeles Lumber Products Company, Ltd., . . . L. ed. (Adv. Op.) . . . .*

This case seems to hold (a) that consent of creditors exceeding the statutory requirements is not evidence the plan is "fair or equitable" in a reorganization proceeding under 77B and (b) as a matter of law the plan is not "fair or equitable" if stockholders in an insolvent corporation having liabilities in excess of its assets are allowed to participate before the full value of the property is first applied to the claims of bondholders.

The case seems to recognize that "composition" may be different from "reorganization." It is said in the foot note 14:

> "The statutory scheme of Sec. 77B (in those respects which are material here) is in sharp contrast to that which was provided for compositions under former Sec. 12. This court said in Callaghan v. Reconstruction Finance Corp., 297 U. S. 464, 470: 'Reorganizations now permitted under Sec. 77B present certain resemblances to compositions under Sec. 12, which have been commented upon as supporting the constitutionality of the reorganization provisions of Sec. 77 or Sec. 77B. * * * But Sec. 77B contemplates

*Citation not yet available.

> a procedure and results not permissible under Sec. 12. Reorganizations are nowhere referred to in the statute as compositions.' Under Sec. 12(a) (as it existed at the time Sec. 77B was enacted) only a 'bankrupt' could offer 'terms of composition to his creditors.' "

"Composition" is a method of adjusting rights among those jointly interested in a common right against the debtor. It is an "agreement" which results, "in the main" from "voluntary acceptance" by creditors (*Louisville Joint Stock Land Bank v. Radford,* 295 U. S. 555, 55 S. Ct. 854, 79 L. Ed. 1593 at 1602). Obviously its essential feature is the "scale down of the debtor's debts."

If there is a distinction between "reorganization" and "composition" the *Los Angeles Lumber Products Company* case is not in point here because Chapter IX unquestionably provides for "composition" not "reorganization." The word "reorganization" does not appear in the chapter. To the contrary, throughout it provides for "composition." Indeed that is one express point of difference between Chapter IX and the law held invalid in the *Ashton* case, 298 U. S. 513; 56 S. Ct. 892; 80 L. Ed. 1309, and Chief Justice Hughes in the opinion in the *Bekins* case, 304 U. S. 27; 58 S. Ct. 811; 82 L. Ed. 1137, emphasizes the "composition" feature and in contrast, says the law stricken down in the *Ashton* case was one for "readjustment of debts." And finally, in the *Bekins* case the complaint was held to state a case. It alleged that the district had offered a plan of composition which provided for the payment to its bondholders of cash equal to 59.988 cents for each dollar of principal

due—in other words a scale down. Similarly, in *Luehrmann v. Drainage Dist. No. 7,* 104 Fed. (2d) 696, *supra,* bonds were, by the plan of composition, scaled down to 25.879 cents on the dollar.

The *Los Angeles Lumber Products Company* case seems to give no effect to the "consents" filed by creditors except as they evidence compliance with the statute. In a composition proceeding where, as we have seen, consents evidence "agreements" "in the main" between those interested in a common right, it would appear some weight might properly be accorded on the issue of fairness where the consents, in the language of the trial court here, "exceed the statutory requirements by nearly 25%."

In the *Luehrmann* case, *supra,* the overwhelming consent of the bondholders to a scale down plus appreciation in the value of the bonds was regarded as sufficient to uphold a finding that the plan is "fair and equitable", the court saying at page 703:

> "* * * The amount of 25.879 cents on the dollar to be paid on outstanding indebtedness is found, and appears to be, fair and equitable, and 'all that could reasonably be expected under all the existing circumstances.' It appears that some of these bonds had theretofore sold for as little as five cents on the dollar. An overwhelming statutory majority of creditors of all classes have accepted the plan, and, in our judgment, the decree of the district court approving it was right and should be affirmed."

By its denial of certiorari in that case the same day the *Los Angeles Lumber Products Company* case was decided, the Supreme court must have had in mind that a

composition plan would be upheld as fair and equitable where the "scale down" of the bonds was approved overwhelmingly by the creditors and the offer had increased the value of their bonds.

A composition proceeding where there is no more than the statutory consent (66%) is one thing. It becomes quite different as the percentage of consent increases. In a composition proceeding it would seem the evidence of fairness should be stronger where 99.5% of the creditors consent than in one where there is a bare 66%.

There are other obvious distinctions between "reorganization" of a corporation and "composition" of the debts of a public agency not only in the vital public interest attaching to the latter but also because of the essential and fundamental differences between a corporation and a public agency. In the former there may be foreclosure, sale, liquidation and distribution of the corporate property, but not in the latter. Furthermore, Section 83 provides that the plan shall be confirmed if the court is satisfied, among other things, that it is "fair, equitable and *for the best interests of the creditors.*" The phrase "best interest of creditors" does not appear in Section 77B. Undoubtedly under Section 83 if the plan is "for the best interests of the creditors" as in the *Luehrmann* case and as here that is a factor in determining whether it is fair and equitable. The record in the instant case is replete with evidence that the plan is for the best interests of creditors.

But it is not necessary to argue in greater detail the manifest differences between Section 77B and Chapter IX based on composition because the plan in this case

was fair and equitable even according to the standards of the *Los Angeles Lumber Products Company* case and entirely irrespective of the consent feature and the benefit to bondholders.

The Plan is Fair.

First: All bondholders were treated exactly alike and all were on a parity. Between them there was no preference or priority. (See Answer to Proposition Fifth pp. 74 et seq. this brief that there were no preferences between them.) The offer is a uniform percentage of the claim as in the *Bekins* case.

Second: To determine whether the plan of a public agency is fair the fundamental question must be what can the debtor pay—what is the maximum bearable debt load of the district? It avails the bondholder nothing if that load is exceeded. As Chief Justice Hughes points out in the *Bekins* case (82 L. Ed. at p. 1145). When landowners cannot pay assessments adequate to service their obligations, the power of taxation is "useless". Under such circumstances Mr. Justice Cardozo says in the *Ashton* case (80 L. Ed. p. 1316), the command to tax is "merely futility" (see R. 409).

You can't bring men to land without water and you can't water the land and make it produce unless someone can operate it successfully and pay off the debt. In order to meet a bonded debt, the farmer must not only be brought to the land but kept there under conditions where he can pay the indebtedness. Unless the man on the land is able to pay his assessment, it is not paid. It is pyramided the next year; if it is not paid in that year

it is pyramided in the following year; until finally it gets to the point where the burden is so heavy that nobody can pay it and it results in a complete breakdown. From the standpoint of the bondholder as well as the landowner, that is one thing which must be avoided.[10]

Also in determining the maximum debt, account must be taken of revenue that is required by the district for operation and maintenance over and above the amount required to service the bonds. Once the district ceases to have adequate funds for operation and maintenance canals become clogged, water rights are lost and eventually the lands revert to their desert character.

What is the maximum debt load the Merced Irrigation District can carry with some assurance of safety? It requires approximately $500,000.00 a year for operation, maintenance and capital betterments (R. 513). Roughly, this will take a sum equal to all the net power revenue and a little more, even on appellants' estimate (R. 527).[11] Cash reserves obviously are necessary against agricultural depressions, droughts, flood years, etc. What can the lands pay for bond service in addition?

Considering that perfection is impossible and that many intangibles are involved whose exact weight is not determinable with mathematical accuracy it is submitted that the offer of the R. F. C. is the limit and more than the

10. In Acquisition and Improvement District No. 36 in San Diego County, the Board of Supervisors this year levied as high as $283,247.54 per $100 of assessed valuation—the result of pyramiding delinquencies. A $10,000.00 investment on that basis would entitle one to a tax bill for the fiscal year 1939-40 of some $28,000,000.00. The process of pyramiding delinquencies is described in *Provident Land Corporation v. Zumwalt*, 12 Cal. (2d) 365 at 370, et seq., 85 P. (2d) 116, and in preamble of California Irrigation District Act, Stats. 1937, Chap. 24, quoted in part in Appendix B herein.

11. The district's estimate based on actual experience was that the net yield would be less than $400,000 annually (R. 407, 408).

limit of considered and conservative judgment. Some leeway too, must be allowed the trier of facts on the exact quantum the district can pay. There is no yardstick that can measure the ability to pay with certainty and as said in *Getz v. Edinburgh Cons. Ind. School Dist.*, 101 Fed. (2d) 734, these cases necessarily present practical problems (p. 736).

The R. F. C. concluded the district could not carry a greater loan than the plan provides for. Remember too, that that is on a basis of 4% interest. The principal load would have to be less if the cost of money were greater and it undoubtedly would be a higher interest rate if some agency other than a relief agency of the Federal Government were the banker. However, there was no evidence of any other offer to refund the bonded debt, except the R. F. C. offer.

For that reason alone the plan is fair and it is more than fair to the bondholders based on the testimony and very able economic study and report of Dr. Benedict on the taxpaying ability of the district (Ex. 35). This was brought up to date by the testimony of the witness Momberg showing that even today the lands are not operating at a profit. The testimony of Dr. Benedict and his report (Ex. 35) has been reviewed at pages 4 to 6, *supra,* and will not further be reviewed here except to say that it is conclusive that the lands of the district cannot carry a tax rate in excess of what the present plan will require—perhaps not that much over a period of years but that is the risk of R. F. C.

The Benedict report comes from the highest source—the University of California. It was disinterested, im-

partial, in the public interest and designed to solve a crying public problem. It was made in cooperation with both bondholders and the district and answers every objection made by appellants on fairness. The statement of the case herein points out much other evidence which is relevant on the issue of fairness.[12] We respectfully direct attention to this—particularly pages 7-19, *supra,* without repeating it and submit that fairness is clearly established.

The court found: (a) that it was the R. F. C. transaction which saved the district from financial ruin and appreciated the value of its bonds from 18 cents to more than 50 cents on the dollar and that without the plan they would be worth much less; (b) that when default occurred in 1933 the lands of the district could not even pay the costs of operation, delinquencies having reached 62% in an effort to service the bonds; (c) the productivity of the land and its revenue are now little, if any, better than they were in 1933; (d) the current hopeful fiscal condition of the district is primarily attributable to the present plan and secondarily to the providential water supply which has enabled the district to earn unprecedented revenue from its power facilities during the last two or three years. In particular the court notices the testimony of Dr. Benedict and the Benedict report and the evidence of the witness Momberg (*In re Merced Irr. Dist.,* 25 Fed. Supp. 981, at page 985, and see formal findings R. 214).

There is no showing that the district can pay a higher tax rate than the plan requires without delinquencies that rapidly pyramid. Once the tax rate goes above a safe rate

12. Note also reports by Districts Securities Commission (Exs. 29-33, R. 678-732) on ability of district to pay.

what has been aptly called the "galloping disease" of insolvency is in full sweep. In truth anyone familiar with irrigation districts and particularly the Merced Irrigation District, will realize at once that even such tax rate as the plan will require is exceedingly precarious from the standpoint of the R. F. C.

Appellants speak of the almost unlimited funds that could be raised by increasing the tax rate in the cities of Merced, Atwater, etc. But here they show an utter lack of comprehension of the practical working of the tax in an irrigation district. They grind incessantly. They take no account of good times or bad times, of drought or flood; if they are not paid they are cumulated in the next year and in the next and the next. If the rate exceeds what the agricultural lands can pay they go delinquent and the delinquencies go on to the city. And in the city they go from one piece of property to another like a house of cards falling down until they cumulate to a point that nobody can pay and there is utter collapse.

All parties here conceded refinancing was essential (R. 495). But in all the years that have elapsed since the district attempted to refund, dissenting bondholders right up through the trial did not even attempt to put forward any plan much less any alleged fairer plan. At times they mentioned the First Refunding Plan, but without any particular enthusiasm. Confronted by a request from the court at the conclusion of the evidence that a modified plan be submitted, appellants (R. 164-167) modestly suggested that a "fairer" plan would be to give the dissenting bondholders 100% of their principal with some minor adjustment of interest; in other words, give over 90% of the

creditors who make the adjustment possible little more than 50% of their principal and give the dissenters 100%.

Respecting this proposed modification the court points out that it is "inequitable, discriminatory, illegally preferential and unjust"; it "financially penalizes approximately 91% of the bondholders who consented to the plan" and permits "less than 10% * * * to reap an unjust enrichment" (25 Fed. Supp. 985); also, the trial court holds the suggested change would upset present and prospective necessary improvements and throw the entire contractual arrangement with the R. F. C. into uncertainty.

It is respectully submitted the foregoing is a complete refutation of the argument against the fairness of the plan and that it meets the strict standards of the *Los Angeles Lumber Products Company* case, *supra.* See also the arguments and discussions in:

In re Corcoran Irr. Dist., 27 Fed. Supp. 322;

In re Lindsay-Strathmore Irr. Dist., 25 Fed. Supp. 988;

Supreme Forest Woodmen Circle v. City of Belton, 100 Fed. (2d) 655;

Getz v. Edinburg etc., School Dist., 101 Fed. (2d) 734;

In re Drainage Dist. No. 7, 25 Fed. Supp. 372;

Vallette v. City of Vero Beach, 104 Fed. (2d) 59 (certiorari denied by Supreme Court Oct. 9, 1939).

On the other hand, if overwhelming consent and benefit to bondholders are factors, as the Supreme Court seems to imply in its action in denying certiorari in *Luehrmann v.*

Drainage Dist. No. 7, 104 Fed. (2d) 696, it is not even debatable the plan is fair and equitable and should be confirmed.

Answer to the Specific Contentions of Appellants Under Fourth Proposition:

Appellants list many objections, most of them supercritical, which they claim render the plan unfair. They point to a few trees but give the court no idea of the forest. They do not review the evidence as a whole to show it does not sustain the finding that the plan is fair. For the most part they have been answered herein and the *Luehrmann v. Drainage Dist. No. 7,* 104 Fed. (2d) 696, specifically overrules many of them; nevertheless without further review of the *Luehrmann* case we supplement the answers as follows:

A. The Plan is Not Discriminatory.

(1) *All* creditors are offered $515.01 for each $1000 bond. The R. F. C. merely advances the money necessary to make the composition effective and in turn accepts refunding bonds for the total amount. No other form of composition would be practicable.

(2) The money which the R. F. C. used to purchase the bonds was put up in the interest of the creditors and the district alike. No new money could be secured without interest and this was new money thrown into an insolvent enterprise. It brought up the value of the bonds from 18 cents on the dollar to more than 50 cents (per Judge McCormick, *Merced* case p. 985). If the R. F. C. offer were withdrawn today the bonds would scarcely have even a nominal value.

Obviously it was proper to pay interest on this new money. *Luehrmann v. Drainage Dist. No. 7,* 104 Fed. (2d) 696; *Zavelo v. Reeves,* 227 U. S. 625, 33 S. Ct. 365, 57 L. Ed. 676. The benefit which accrued to the creditors and the district clearly justified the payment. Furthermore, dissenting bondholders could have taken cash at any time since the first disbursement was made by the R. F. C. and the money so taken would have had the earning power of interest. They voluntarily chose to relinquish the earning power or interest by holding their bonds.

(3) All bondholders were treated alike. There was no discrimination. Appellants were entitled to 4% on the liquidating value of their bonds from the time they were made available for refinancing up to October 4, 1935 (R. 761). Thereafter cash was available at all times (R. 351). This is precisely what all bondholders were offered and there was no favoritism. Appellants have chosen voluntarily to waive the income on the liquidating value of their bonds.

The case of *In re James Irrigation District,* 25 Fed. Supp. 974 at 975, does not support appellants' claim. In that case the interest which the court ordered paid had been paid in all transactions with all consenting creditors (p. 975). The same situation did not exist in either the *Merced* or the *Lindsay-Strathmore* cases decided the same day and by the same judge (McCormick). *In re Merced Irr. Dist.,* 25 Fed. Supp. 981; *Lindsay-Strathmore Irr. Dist.,* 25 Fed. Supp. 988. In neither of these cases, accordingly, was there any requirements for the payment of interest.

4. There is no authority under the law for the Merced Irrigation District to readjust or refinance the obligations of other independent taxing agencies. The plan cannot be unfair in respect to a power which the district could not lawfully exercise. See answer to Tenth Proposition (a), *infra.*

5. The plan does not take property from the bondholder and give it to a junior encumbrancer. Nor is there any similarity between a private corporation and a public agency in the respect noted. See answer to Tenth Proposition (a), *infra.*

B. The Plan is Not Unfair, Inequitable or Against the Best Interest of Creditors.

(1) The plan does not take trust funds or properties from appellants. All bondholders are in precisely the same class and the $515.01 for each $1000 bond represents the prorated cash value of the maximum load the district can carry.

(2) The bondholder does not give up over 53% of his investment or any part thereof "in order to benefit the landowner." The senior creditor does not give up anything. The $515.01 represents a value his bond did not have except for the relief accorded by the R. F. C. and the plan itself. The value of the bond was already largely gone. The plan gave it back in part. The bondholder gives up no value but gets $515.01 for a bond which was worth about 18 cents on the dollar on the market (R. 500).

(3) Appellants say that if inflation comes the district can liquidate its debts fully with "comparative ease." We will not debate such speculative questions. However,

if inflation comes and appellants still hold their bonds, they may then have very little value, in fact no value comparable with $515.01 in cash today.

(4) Appellants argue that it is impossible to submit a fair plan on a cash basis because no one can tell what the future will bring forth. This is interesting but not enlightening. Refinancing was conceded to be essential and the law authorized a composition offer in cash.

(5) The finding of the Districts Securities Commission on the value of the property is immaterial for the purpose of this proceeding and does not go to the fairness of the plan as the only security for the bonds is the earning power of the district. The value of the land is not the issue but the ability of the land to pay.

(6) What the district could pay was for the court to determine—not the Securities Commission.

(7) It is said that the plan is unfair because petitioner has assets far exceeding its liabilities.

Assets of a public agency are not set up on its books for cash value purposes but to show their cost. These assets are necessary for operation and maintenance of the project but cannot be used to service bonds. If value were the issue, there should be an immediate deduction from assets of $5,500,000, being the cost of relocating the Yosemite Valley R. R. But if, after such revision and others, it should be found that the assets exceed the liabilities, what of it? It is not the assets which measure the ability to pay bonds but earning power. As Judge Yankwich points out in the *Corcoran District* case, 27

Fed. Supp. 322, excess of assets over liabilities does not show ability to pay debts.

On page 65 of appellants' brief it is said that the average value of the lands within the district is about $135.00 per acre, based on the testimony of the witness Momberg. The value of the lands in the district is shown in the Benedict report (Ex. 35, p. 128). (And see Statement of Facts herein, p. 5, *supra.*) Moreover, the witness Momberg was testifying not with respect to the value of district lands generally but to *sales price* of the lands of California Lands, Inc. (R. 485).

(8) Appellants here discuss the power revenue of the district.

Power is dependent upon the most uncertain of all things—the weather. The average gross return from the power plant for 12 full years of operation was $444,939.33 per year. This includes the very dry year of 1931 when the gross revenue was $95,917.21 and the wettest two years (1937, 1938) when the revenue was $625,363.45 and $707,203.96, respectively (R. 407; Ex. 27; R. 676.)

What the plant actually produced over a cycle of 12 years is more important in determining what it will produce in the future, than a theoretical study which goes back to 1872 and is based on what the plant should have been producing had it been in operation. Experience in actual operation is the best test. Dry cycles are impossible to predict, and as pointed out by appellants' witness, Hill (R. 536): "Speaking in terms of dry cycles, if a person were to attempt before that dry cycle commenced

to predict what the future would be, based on the past, he would not get it right." Mr. Hill had made a report on the district in 1924 before the power plant was installed as to what it would produce "based on the experience of the past," and did not "get it right." Before the plant had been built he predicted "based on the experience of the past that the yield would vary from a *minimum of $300,000* to a maximum of $700,000 per year" (R. 536-538).

The value of the power revenue to the district was given full consideration by the R. F. C. in its loan. Without a prospective high yield in power revenue, the R. F. C. would have paid much less than 50% for the bonds. Due weight was also given to the contract for sale of power which is a very favorable one. It will expire in 1964 (R. 946). Thereafter, no one can conjecture what the price of power will be, considering that Central Valley, Grand Coulee, Bonneville, Boulder Dam and other projects may be fully developed; neither can it be profitably conjectured as to whether in the next ten or fifteen years there may not be a series of dry years which would practically wreck the district; or, conversely, there may be a series of wet years which will bring in increased power revenue but greatly increase the amount of money to be paid for operation of the district in taking care of high water conditions and protecting against floods (R. 513). The power revenue is an interesting thing to play with in making speculations and conjectures. But no conservative financial man would give a greater weight to that revenue than was given by the R. F. C.

The trial judge sums up the power situation, very clearly and accurately, pointing out that the water supply during the last two or three years has been "providential" and enabled the district to earn

> "unprecedented revenue from its power facilities. But the experiences of the past, as shown by the record before us, do not warrant a finding that power revenue conditions similar to those existing will continue in the future, and it would be injudicious to venture the further financial ability of the District to meet its obligations upon problematical water sources or conditions. This would be too dubious a situation to warrant adoption by the court." (25 Fed. Supp. 986.)

9. It is said that petitioner could pay off its debt in full on petitioner's own theory. The contrary is shown by every syllable of testimony. Delinquencies have been reduced because the tax rate has been kept low. The cash reserves are the result of the operations of the R. F. C., the fact that maintenance expenditures have been deferred, capital operations postponed and to a "providential" power yield.

10. It is said here that the district comprises a fertile and good section of the state.

Without taking issue with appellants on this, we point out that for the purpose of this proceeding the condition of the district, the value of its lands, and the ability to pay assessments are best covered in the Benedict report, including the classification of lands by Mr. Cone (Ex. 35, pp. 126-133), the testimony of Dr. Benedict and Mr. Momberg (R. 432 to 494) and the letter of the bondholders' committee dated December 15, 1933 (Ex. 37, R. 736).

11. A sufficient answer here is that the exhibits presented by petitioner showing its financial condition were practically as of the date of trial (Exs. 22-28, R. 661-678).

ANSWER TO FIFTH PROPOSITION: "THE CLAIMS WERE IMPROPERLY CLASSIFIED AS BEING ALL OF THE SAME CLASS."

1. On Appellants' Theory There Would Be About 200,000 Classes.

If we correctly understand appellants, they argue that "Each matured bond and coupon when presented for payment becomes a separate class" (Apps.' Brief, p. 75). There are roughly 16,000 bonds in the Merced issue. Each carries two coupons a year, no interest has been paid since July 1, 1933, and practically all of the coupons have at varying times been presented for payment and registered unpaid for want of funds. In addition, $386,000 in principal was in default at time of trial (R. 401) and these bonds too, have been presented for payment and registered. Most of them are owned by the R. F. C. (Apps.' Brief, p. 60).

If, as appellants claim, each such matured bond and coupon becomes "a separate class" (Brief, p. 75) there will be about 200,000 classes.

2. On the Facts Appellants Show No Injury.

Passing this, however, and assuming that there is a priority or preference as between bonds and coupons in bankruptcy, appellants wholly fail *on the facts* to show any injury from the alleged failure of the court to classify. A mere showing that appellants' own matured

bonds and coupons which have been presented for payment and registered is not enough because the record shows that *all of the bonds and coupons held by the R. F. C. have also been presented for payment and registered.* The mere registration of the bonds in the name of the R. F. C. as owner is, under *Bates v. McHenry,* 123 Cal. App. 81, at p. 92, 10 P. (2d) 1038, an automatic presentation and registration. And prior to the registration of the bonds in the name of the R. F. C. as owner the former owners were vigilant in presentation for payment.

The bond register of the district showing the exact order of presentation of matured bonds and coupons was not put in evidence for the reason that appellants did not make any point of it at the time of trial. A long and tedious accounting would be required to fix the exact order of presentation. But the testimony is clear that the bonds and coupons held by the R. F. C. have at least as early presentation dates as those of appellants (see R. 520, 887). While the record, therefore, is admittedly incomplete, it wholly fails to show that appellants are injured by failure to classify in accordance with presentation. If that was required, they show no facts (Brief, p. 76) that do not equally apply to the R. F. C.

If the money in the treasury of the district is to be paid out to those having matured bonds or coupons in the order of their presentation for payment, it is quite sure that the R. F. C. will get at least 90% of the available funds and probably a great deal more because appellants will not deny that, for the most part, it holds the earliest presentations. In any event, the burden is upon

appellants to show not only that the court erred in failing to make classification but that they were injured by it.

Scritchfield v. Kennedy, 103 Fed. (2d) 467;
In re Schulte-United Inc., 59 Fed. (2d) 553;
Moores Fed. Practice, Vol. 3, p. 3285, Sec. 61.

3. There is, However, in Bankruptcy No Preference or Priority Based on Presentation.

In the *amicus curiae* brief of the Imperial Irrigation District Bondholders Committee filed in the *Lindsay-Strathmore Irrigation District* proceeding in this court, No. 9206, the authorities are elaborately reviewed and it is shown that the bankruptcy act takes cognizance only of "true priorities"—that priorities created by the state are not recognized if they are "destructive of the purpose and spirit of the bankruptcy act." *Local Loan Co. v. Hunt*, 292 U. S. 234, 54 S. Ct. 695, 93 A. L. R. 195, 78 L. Ed. 1230 at p. 1236. The bonds here are all clearly equal and payable without preference out of annual assessments. They are all in the same class. There can be no preference as between them. It is the general spirit of bankruptcy to ignore "advantages" based on legal proceedings or winning a "race" to the cash register (see: *Vallette v. City of Vero Beach*, 104 Fed. (2d) 59, p. 63, certiorari denied Oct. 9, 1939; *Luehrmann v. Drainage Dist. No. 7*, 104 Fed. (2d) 696, certiorari denied Nov. 6, 1939).

True priorities cannot arise in this case even if *Bates v. McHenry* holds all that appellants contend. We shall not retrace the ground covered in the *amicus curiae* brief in so far as the rule in bankruptcy is concerned but will merely supplement the briefs in the *Lindsay-Strathmore*

case by showing that under the doctrine of *Bates v. McHenry, supra,* and the California law there is no priority or preference.

Bates v. McHenry, supra, and subsequent cases cited by appellants do not establish the California rule as they contend. They establish the opposite, namely, that once the fund is not replenishable, in other words, when bankruptcy intervenes, there is no preference but all creditors are equal. A careful reading of the cases will show that this is true.

Judge McCormick in his opinion in *In re James Irrigation District,* 25 Fed. Supp. 974 at 975, clearly, correctly and forcefully states the California rule and shows there is no preference under the state law. In the *amicus curiae* brief filed by Lynn Atkinson in the *Lindsay-Strathmore* proceeding here, No. 9206, the opinion on this point is said, at page 51, to be a "rather superficial opinion" but it is not the opinion which is superficial, but counsel's reading of the California cases.

A close study of *Bates v. McHenry* and subsequent cases will show that preference was never intended to be applied where there is insolvency and the fund is not replenishable.

Bates v. McHenry, 123 Cal. App. (at pp. 91, 92) 10 P. (2d) 1038, definitely recognizes that the rule would be different in case of insolvency. The decision is based upon the ground that all bondholders will be paid in full out of a replenishable fund. Those who are not paid on presentation receive 7% interest. "Thus, *absolute equality* is meted out between the coupon holder who receives in-

stant payment and the coupon holder whose payment is deferred."

Shouse v. Quinley, 3 Cal. (2d) 357, 37 P. (2d) 89, 45 P. (2d) 701, again, did not deal with insolvency; it merely held that to permit application of bonds on assessments would reverse the normal order of payment as provided by Section 52. Clearly the law there involved was unconstitutional, and the case not only affords no support for appellants but establishes that *no preference can be allowed in favor of bondholders as against others holding registered bonds.*

In *Selby v. Oakdale Irrigation Dist.,* 140 Cal. App. 171, 35 P. (2d) 125, it is again recognized, citing *Bates v. McHenry,* that there is ordinarily no priority as to any of the bonds issued by the irrigation district. There is nothing in that case to support the claim that Section 52 would be applied in bankruptcy.

Passing the decision in *Provident Land Corporation v. Zumwalt,* 12 Cal. (2d) 365, 85 P. (2d) 116, and companion cases, for the moment, it is manifest that all of the irrigation district cases cited by appellants are cases which do not involve insolvency, and a reading of these cases carefully—particularly the leading case of *Bates v. McHenry*—will demonstrate that they all recognize that any priority will disappear in the event that the fund is not replenishable.

Turning now to the reclamation district cases, it will be found that, commencing with *Rohwer v. Gibson,* 126 Cal. App. 707, 14 P. (2d) 1051, they all recognize that the annual funds must be prorated among the maturities for

the year, for the simple reason that in a reclamation district such annual funds are not replenishable. In other words, *they are direct authority for the rule that if the fund is not replenishable the money must be prorated.* Furthermore, these reclamation district cases distinguish the irrigation district cases upon the very ground that the holder of a bond of an irrigation district "relies upon the inexhaustible taxing power of the district." Obviously, however, if bankruptcy intervenes and the district is insolvent, or in the language of the Bankruptcy Act "unable to pay its debts as they mature," there is nothing to rely on for the replenishment of the fund.

The rule in reclamation districts has even been carried so far that if the reclamation district is insolvent then the holders of *all bonds, matured* and *unmatured,* are entitled to share in any available funds. This was so held by the Third District Court of Appeal in the recent case of *Morris v. Gibson,* 30 Cal. App. (2d) 684, 87 P. (2d) 37, although the district in that case was held not to be insolvent. The *Sturdivant Bank* case cited therein with approval (68 S. W. (2d) 671, Mo. 1934) and also the case of *Groner v. U. S.,* 73 F. (2d) 126, are particularly interesting and demonstrate that once insolvency is established or bankruptcy intervenes, there can be no preference. There must be equality.

Summarizing the reclamation and irrigation district cases to date, it appears that both lines of cases recognize that where funds applicable to the payment of bonds of the same class cannot for any reason be replenished, equality is equity and the money must be prorated. It is because ordinarily in a reclamation district the annual

fund is *not* replenishable and because in an irrigation district it ordinarily *is* replenishable that we have one situation in a reclamation district (evidenced by *Rohwer v. Gibson, supra*) and another situation in an irrigation district (evidenced by *Bates v. McHenry, supra*).

Of course, the answer to everything that appellants claim is found in the case of *Kerr Glass Manufacturing Corporation v. San Buenaventura*, 7 Cal. (2d) 701, 62 P. (2d) 583, which is doubtless conclusive because it fully discusses the applicable general principles; and it does not help appellants to pass this off as a special assessment case any more than it does to pass the reclamation district cases off as involving special funds, for the reason, as noted above, that the principles underlying these cases, 'the reason for the rule', definitely support our thesis.

The case of *District Bond Company v. Cannon* (20 Cal. App. (2d) 659, 67 P. (2d) 1090) upholding and following the *Kerr Glass Manufacturing Corporation* case, is further authority for our contention as well as *Strasburger v. Van Delinder* (17 Cal. App. (2d) 437, 62 P. (2d) 387) in which, however, there was no showing that the fund could not be replenished.

It is really the case of *Provident Land Corporation v. Zumwalt*, 12 Cal. (2d) 365, 85 P. (2d) 116, and companion cases, upon which appellants rely. But a careful examination of these cases will show that the cases themselves are not only not contrary to our theory, but definitely support it. Obviously (there being nothing else involved) to permit one group of bondholders, as in the case of *El Camino Irr. Dist. v. El Camino Ld. Corp.* (12 Cal. (2d) 378, 85 P.

(2d) 123), to take the lands of an irrigation district on execution would *give them a preference as against bondholders who had presented their bonds for payment.* This, however, does not mean that in a proper case *all* bondholders would not have to share in the common fund. The court says on page 374 of 12 Cal. (2d) of the *Provident Land Corporation v. Zumwalt* case that where a surplus exists "first, this money should go to the bondholders; and second, in any event, *it should not be given to junior bondholders in preference to those with prior claims,* but should be paid on past due bonds and coupons in the order of their presentation." If these sentences are lifted from the decision, unrelated to its other parts, they may be confusing. But not if it is remembered that junior bondholders had secured a preference as against registered bondholders in that case and it was this preference which the court by its decision set aside. In that case the question was simply whether the district had made an erroneous and unlawful distribution of money from the bond fund, or which should have been in the bond fund, to bondholders who admittedly were not entitled to it. Of course, if the money should have gone into the general fund the district clearly could not disburse it so as to create a preference as against bondholders who held the prior registration. Later in the decision it is made clear that the court is not abandoning the rule of the *Kerr Glass Manufacturing Corporation* case, 7 Cal. (2d) 701, 62 P. (2d) 583, because it is definitely referred to with approval and, concluding the decision, as if to forestall any possibility of misconstruction, the court in the *Provident* case, speaking of the *Kerr* case, says at page 379:

"* * * we recognized the justice of applying equitable principles to the payment of bondholders in unusual circumstances, notwithstanding the fact that express provisions of the statute stood in the way."

And then the court says (quoting):

"'The trust status of the fund has been considered appropriate where it is theoretically replenishable by a so-called inexhaustible taxing power, but the exercise of that power is rendered fruitless by reason of economic conditions resulting in a tax-collecting incapacity.'"

There can be no question that had the same question we are considering here been involved or raised in the *Provident Land Corporation v. Zumwalt* case the court would have applied the rule of the *Kerr Glass Manufacturing Corporation* case and held that there was no preference in the common fund.

Appellants seek comfort in the modification of the opinion in the *Provident Land Corporation v. Zumwalt* case. In the Irrigation Districts Association amicus curiae brief, however, in the *Lindsay-Strathmore* proceeding here, No. 9206, at page 25, et seq., the full request for modification (with certain vital parts omitted by appellants) is quoted. From this it appears that the reference by the California Supreme Court to the *Kerr Glass* case in *Provident Land Corporation v. Zumwalt* case was purposeful and the meaning attempted to be put on the modification of the opinion by appellants entirely loses its significance.

We shall not retrace the history of the modification as it is fully set forth in the amicus brief. It is obvious,

however, that the California Supreme Court wished to protect its opinion as against the very construction now placed upon it by appellants.

ANSWER TO SIXTH PROPOSITION: "THE DECREE UNLAWFULLY TAKES TRUST FUNDS AND VESTED RIGHTS BELONGING TO THE APPELLANTS."

Here appellants go around in a circle. They say that because the district held certain property in trust "for the uses and purposes" set forth in the "Irrigation District Act", including the payment of bondholders, and because there was a vested right to a writ of mandate and the levy of assessments at the time the district filed in bankruptcy, and because these rights are affected by the bankruptcy decree, therefore the decree must be invalid. The proposition advanced is a negation of the whole theory and philosophy of bankruptcy except to the extent that the decree is alleged to have destroyed liens or preferences. It has been shown, however, under the answer to the Fifth Proposition that there is no lien or preference as between the bondholders.

The very object of bankruptcy laws "is the equitable distribution of the debtor's assets amongst his creditors".

In *Kuehner v. Irving Trust Co.*, 299 U. S. 445, 57 S. Ct. 298, 81 L. Ed. 340 at 345, the court pertinently says:

> "The short answer is that the object of bankruptcy laws is the equitable distribution of the debtor's assets amongst his creditors"

even though the debtor's contract is impaired.

At page 346:

"(The Fifth Amendment) does not prohibit bankruptcy legislation affecting the creditors' remedy for its enforcement against the debtor's assets or the measure of the creditors' participation therein if the statutory provisions are consonant with a fair, reasonable and equitable distribution of those assets."

And at page 346:

"Bankruptcy originated as a seizure of the debtor's assets for equitable distribution amongst creditors."

The purpose of reorganization proceedings under Sec. 77B[13] was to "facilitate rehabilitation" by "scaling or rearrangement" of obligations,

"thus avoiding a winding up, and sale of assets, and a distribution of the proceeds."

City Bank Farmers Trust Co. v. Irving Trust Co., 299 U. S. 433, 57 S. Ct. 292, 81 L. Ed. 324 at 329.

In *Louisville Joint Stock Land Bank v. Radford,* 295 U. S. 555 at p. 585, 55 S. Ct. 854, 79 L. Ed. 1593 at p. 1602, the court says:

"So far as concerns the debtor, the composition is an agreement with the creditors in lieu of a distribution of the property in bankruptcy—an agreement which 'originates in a voluntary offer by the bankrupt, and results, in the main, from voluntary acceptance by its creditors * * *"

13. Composition proceedings present a much stronger case (see discussion of *Case v. Los Angeles Lumber Products Co.*, decided November 6, 1939, at pp. 55, et seq., *supra*.

ANSWER TO SEVENTH PROPOSITION: "BY THE TERMS OF THE STATUTE THE COURT WAS WITHOUT JURISDICTION."

Under this heading appellants make a labored argument designed to prove that, although the Supreme Court in the *Bekins* case, 304 U. S. 27, 58 S. Ct. 811, 82 L. Ed. 1137, held that Sections 81 to 84 of the Bankruptcy Act were constitutional as applied directly to an irrigation district organized under the California Irrigation District Act, there have been late cases decided by the California Supreme Court which establish some entirely new and novel rule with respect to the status of irrigation districts, and that therefore the *Bekins* case should be disregarded.

Appellants take this position notwithstanding that (a) the very basis for the decision in the *Bekins* case in the lower court was that an irrigation district is an agency of the state performing governmental functions and within its sphere exercising the "powers of sovereignty" (*In re Lindsay-Strathmore Irrigation District,* 21 Fed. Supp. 129 at page 134); and (b) that this question is fully considered in the briefs in the United States Supreme Court.[14]

Judge Yankwich who wrote the learned opinion in *In re Corcoran Irr. Dist.,* 27 Fed. Supp. 322, in the lower court, and who ought to know, points out at page 328, that the recent decisions of the California Supreme Court relied upon by appellants, "have not changed the law as I found it to be" in the first *Lindsay-Strathmore Irriga-*

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14. At page 1140 of 82 L. Ed. abstract of briefs of the parties in the *Bekins* case. Mr. Cook and Mr. Childers representing many of appellants here, cite *Moody v. Provident Irr. Dist.*, 77 P. (2d) 253 on the governmental nature of irrigation districts. In the decision of the California Supreme Court on rehearing the same language on the governmental nature of irrigation districts is adopted verbatim. *Moody v. Provident Irr. Dist.*, 12 Cal. (2d) 389, at 394, 85 P. (2d) 128.

tion District case, 21 Fed. Supp. 139. And he adds that the decision of the Supreme Court in the *Bekins* case "is proof that the court understood the nature of California irrigation districts".

The late California decisions cited by appellants do not purport to state any new rule. They do not reverse or modify earlier decisions but merely reaffirm a principle long recognized and established in California with respect to both irrigation and reclamation districts, namely, that they are public agencies vested with attributes of sovereignty and governmental in character. There is slight difference in the shading of the language used from time to time by the California court respecting these agencies but, in the essential attributes its characterization of these districts has consistently remained the same. A mere reading of the recent decisions cited by appellants will show that the Supreme Court was reiterating the rule theretofore uniformly adhered to and applied and that the recent cases add nothing to the rule but on the facts, make a fresh application of familiar principles.

The following cases, all decided prior to the *Bekins* case, are but a few of a list which might be almost indefinitely lengthened:

Sutro Heights Land Co. v. Merced Irr. Dist. (1931), 211 Cal. 670, 690, 296 P. 1088, 1096, 1098;

Nissen v. Cordua Irr. Dist. (1928), 204 Cal. 542, 545, 269 P. 171;

Whiteman v. Anderson-Cottonwood Irr. Dist. (1922), 60 Cal. App. 234, 237, 212 P. 706;

Morrison v. Smith Brothers Inc. (1930), 211 Cal. 36, 40, 293 P. 53, 54;

In re Madera Irr. Dist. (1891), 92 Cal. 296, 28 P. 272, 675, 14 L. R. A. 755, 27 Am. St. Rep. 106;
People v. Sacramento Drainage Dist., 155 Cal. 373, 382, 103 P. 207;
Bettencourt v. Industrial Acc. Com., 175 Cal. 559, 561, 166 P. 323;
Western Assur. Co. v. Drainage Dist., 72 Cal. App. 68, 72, 237 P. 59;
Wood v. Imperial Irr. Dist., 216 Cal. 748, 753, 17 P. (2d) 128;
La Mesa etc. Dist. v. Hornbeck, 216 Cal. 730, 737, 17 P. (2d) 143.

But aside from the foregoing, appellants miss the entire point of the *Bekins* case, which is that a voluntary proceeding brought by an irrigation district with the consent of the State cannot in any sense "interfere" with the sovereignty of the State. The very issue determined was that such a proceeding is not "interference". And in making the point under discussion, appellants are simply disregarding realities and asking this court to overrule the Supreme Court.

In *Supreme Forest Woodmen Circle v. Belton,* 100 Fed. (2d) 655, the court refers to the *Bekins* case and says at page 657:

> "* * * It sustained the act as to the Irrigation District on the ground that it was not an attempt to interfere with its governmental functions."

And again, at page 657, it says concerning the act:

> "* * * it concerns itself with the city as a debtor, not compulsorily, nor by way of interference with it, * * *"

Manifestly under the *Bekins* decision when the agency of the State, with its consent, seeks the aid of the bankruptcy court voluntarily, it acts for the benefit of and not in derogation of its sovereignty. Therefore it cannot be said that the proceeding interferes with the State sovereignty or with the exercise of governmental functions.

ANSWER TO EIGHTH PROPOSITION: "THERE IS ANOTHER ACTION PENDING IN THE STATE COURTS * * *."

Appellants contend that because a proceeding under the "Irrigation District Refinancing Act" (Cal. Stats. 1937, Chap. 24) in the state court was partially tried, petitioner is precluded from offering a plan of composition under Chapter IX of the Bankruptcy Act.

The state act, as has been pointed out in our statement of the case (p. 15, *supra*), provides for condemnation of bonds of dissenting bondholders. The public necessity and foundation for condemnation are first shown at a preliminary trial after which an interlocutory judgment supported by findings of fact is entered, or if the proof fails, the proceeding is dismissed (Sec. 8). In the former situation, the right to condemn has been established and thereafter the case proceeds as an ordinary condemnation proceeding at which the value of the dissenting bonds are fixed by trial. Upon payment of the value so fixed the bonds are taken for public use (Secs. 10-11).

The state action in question had proceeded merely through the preliminary stages and the judge had announced a decision in favor of the district on the right

to an interlocutory judgment. As heretofore pointed out in our statement of the case, nothing further was done. The district elected to claim the benefits of bankruptcy composition after the Supreme Court held Sections 81-84 constitutional and this proceeding is the result.

Heretofore appellants insisted that the state act is a bankruptcy act impairing the obligation of contracts and that it is unconstitutional and void.

> *Morris v. South San Joaquin Irrigation District,* 9 Cal. (2d) 701 at 704, 72 P. (2d) 154.

That is primarily the ground upon which the state proceeding was resisted.

Of course, if this contention is sound and the act impairs the obligations of the contract, it is simply void and ineffectual.

> *International Shoe Co. v. Pinkus,* 278 U. S. 261, 49 S. Ct. 108, 73 L. Ed. 318.

On the other hand, if the state act is not a bankruptcy act, petitioner was entitled to the benefits of bankruptcy. Certainly because the district had commenced an action to condemn it did not forego the right granted it by Congress to effect a composition of its debts in bankruptcy.

In either event, it is plain that the state case was superseded by this proceeding.

Appellants say the authorities cited in their brief (pp. 98-99) support their contention that proceedings under state insolvency laws, pending at the time of passage of a federal bankruptcy act are not affected by the latter act. It is doubtful if they do support such claim but, if so, they

are bad law except insofar as the original Bankruptcy Act expressly saved certain state proceedings. This saving clause has since been stricken out.

Says Mr. Remington:

> "Sec. 2104. *Basis of Supersedence, Paramount Authority Conferred by Constitution, and Necessary Implication from Sec. 70.*—The superseding of State bankruptcy and State insolvency proceedings comes about from the fact that the Constitution of the United States in Article 1, Sec. 8, authorizes Congress 'to establish * * * uniform laws on the subject of bankruptcies throughout the United States'; and that Sec. 71 of the original Act, 11 U. S. C. A. Sec. 111 (since stricken out on Amendment as being no longer necessary), providing that 'Proceedings commenced under State insolvency laws before the passage of this Act shall not be affected by it', necessarily implies the superseding of all other classes of State insolvency proceedings than those expressly excepted."
>
> *Remington on Bankruptcy,* Vol. 5, Fourth Edition, Sec. 2104, page 192.

From 8 C. J. S., p. 422:

> "A state court may be prohibited from acting under a state insolvency law and any proceedings under such a state law commenced after the national law went into effect are void and ineffective, except that *where proceedings are commenced under a state act that is not in reality a bankruptcy act but is in harmony with the federal Bankruptcy Act and in aid of its purpose, while all proceedings thereunder are superseded when a bankrupt proceeding is begun, the bankruptcy court may avail itself of the status and*

proceedings then existing in the state court where such status or proceedings may aid in the administration by the bankruptcy court of the bankrupt's property.''

From

First National Bank of Delta, Pa. v. Weaver, 296 Fed. 112, at p. 114:

''It will thus be seen the state act in question is not a bankruptcy act, but one of insolvency administration, and while all proceedings thereunder are, of course, superseded when a bankrupt proceeding is begun, yet there is no reason why the bankrupt court should not avail itself of the status and proceedings then existing in the state court proceeding where such status or proceedings may aid in the administration by the bankruptcy court, of the bankrupt's property.''

In *In re Dressler Producing Corporation,* 262 Fed. 257, p. 259, the court says:

''* * * We are of the opinion that it was unnecessary to justify a choice, for the petitioners in bankruptcy have the unchallengeable right to proceed by filing this petition. The institution of the proceedings in the state court is not a bar to maintenance of this petition in bankruptcy.''

In *In re Ellsworth,* 277 Fed. 128, the court held that the jurisdiction of a state court in a suit is at once superseded by an adjudication in bankruptcy against the defendant therein, and it is without authority to proceed thereafter; but, where it does so, its judgment against the bankrupt may be accepted by the bankruptcy court as a liquidation of the plaintiff's claim, under the Bankruptcy Act, Section 63b.

In *Collins v. Welsh,* 75 Fed. (2d) 894, 99 A. L. R. 1319, Circuit Judge Wilbur, speaking for this court, held that federal bankruptcy jurisdiction over property of petitioner seeking composition with his creditors superseded state court jurisdiction which had already attached to certain of his property. He points out that the jurisdiction of the bankruptcy court is necessarily paramount. And he further points out that in *In re Faour,* 72 Fed. (2d) 719, where the superintendent of banks of the State of New York, acting under a state law had taken possession of the property of the debtor before the filing of the petition in the bankruptcy court, it was held that the state jurisdiction was superseded, the court saying at page 720:

> "Within its sphere the jurisdiction of a court of bankruptcy is paramount."

So also in *U. S. Bank etc. v. Pamp,* 77 Fed. (2d) 9, 99 A. L. R. 1370, it was held that where a farmer who filed a petition in bankruptcy for a composition with creditors or extension of time to pay debts is still in possession of mortgaged realty against which a decree of foreclosure has been obtained, the bankruptcy court has jurisdiction summarily to enter a decree restraining further prosecution of the foreclosure. This for the reason that bankruptcy jurisdiction when invoked "is paramount", or, as it is sometimes put "supreme" and "exclusive" and "unrestricted".

> *International Shoe Co. v. Pinkus,* 278 U. S. 261, 49 S. Ct. 108, 73 L. Ed. 318;
>
> *New York v. Irving Trust Co.,* 288 U. S. 329, 53 S. Ct. 389, 77 L. Ed. 815;

U. S. Fid. etc. Co. v. Bray, 225 U. S. 205, 32 S. Ct. 620, 56 L. Ed. 1055;

In Re Bank Shares Corporation, 50 Fed. (2d) 94, p. 95;

In Re Drake Motor and Tire Mfg. Corp., 16 Fed. (2d) 142, 145;

In re Mullings Clothing Company, 238 Fed. 58, p. 66;

In re Diamond's Estate, 259 Fed. 70, p. 73;

Louisville Realty Co. et al. v. Johnson, 290 Fed. 176, p. 177.

ANSWER TO NINTH PROPOSITION: "IT IS RES JUDICATA BETWEEN THE PARTIES THAT THE CONSTITUTION FORBIDS THE RELIEF SOUGHT."

1. Appellants argue that the new Municipal Bankruptcy Act is the same law as the old and that the *Bekins* case, 304 U. S. 27, 58 S. Ct. 811, 82 L. Ed. 1137, overruled the *Ashton* case, 298 U. S. 513, 56 S. Ct. 892, 80 L. Ed. 1309. If this be not true their entire argument is pointless because the most they can claim is that the former judgment is conclusive, that Congress had no power to enact Section 80. But if Sections 81-84 are different from Section 80 in fact as well as section number what was determined as to Section 80 can have no bearing on Sections 81-84.[15]

The short answer to appellants' contention, therefore, is that the Supreme Court did regard the two laws as different and did not overrule the *Ashton* case. On the con-

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15. The issue of *res judicata* also was apparently involved in *Luehrmann v. Drainage Dist. No. 7,* 104 Fed. (2d) 696, and resolved against appellants.

trary it expressly held that Congress in enacting the new law, was "especially solicitous" to afford no ground for the objection urged in the *Ashton* case. It is not for appellants to say the court did not mean what it said. In *Supreme Forest Woodmen Circle v. Belton,* 100 Fed. (2d) 655, it is aptly and tersely said on page 657 referring to the decision in the *Bekins* case:

> "* * * it adjudicates fully, completely, and without reservation, that the Ashton case is without bearing or effect on the present Act."

2. But in any consideration of this case the defense of *res judicata* fails. The former action was merely dismissed for want of jurisdiction. This means that, as of the date of dismissal, the court had no jurisdiction.[16] But if the court subsequently acquires jurisdiction by virtue of a new law or even by virtue of a reversal on constitutional grounds of the old law, that is a different story.

It is fundamental that *res judicata* is never applied where there has been a change in the law or the facts after the judgment has been rendered. Assuming that the *Bekins* case overruled the *Ashton* case and that the two laws are identical, the legal effect would be similar to a constitutional amendment. See in this connection dissenting opinion of Mr. Justice Brandeis in *Burnet v. Coronado Oil & Gas Co.,* 285 U. S. 393, 52 S. Ct. 443, 447, 448, 76 L. Ed. 815 at pp. 823, 824:

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16. We concede that jurisdiction or want of jurisdiction can become *res judicata* (*Treimies v. Sunshine Mining Co.,* ...... L. ed. (Adv. Op.) ......, citation not yet available, decided by the U. S. Sup. Ct. Nov. 6, 1939), even if the decision on want of jurisdiction is erroneous.

"* * * But in cases involving the Federal Constitution, where correction through legislative action is practically impossible, this Court has often overruled its earlier decisions. The Court bows to the lessons of experience and the force of better reasoning, recognizing that the process of trial and error, so fruitful in the physical sciences, is appropriate also in the judicial function. * * * Recently, it overruled several leading cases, when it concluded that the States should not have been permitted to exercise powers of taxation which it had theretofore repeatedly sanctioned."

In a footnote, page 826:

"The policy of *stare decisis* may be more appropriately applied to constitutional questions arising under the fundamental laws of those States whose constitution may be easily amended. The action following the decision in Ives v. South Buffalo Ry. Co., 201 N. Y. 271, 94 N. E. 431, 34 L. R. A. (N. S.) 162 Ann Cas. 1912B, 156 shows how promptly a state constitution may be amended to correct an important decision deemed wrong. See Frankfurter and Landis, 'The Business of the Supreme Court,' pp. 193-198. In only two instances—the 11th and the 16th Amendments—has the process of constitutional amendment been successfully resorted to, to nullify decisions of this Court. * * * It required eighteen years of agitation after the decision in the Pollock Case to secure the 16th Amendment."

See also further discussion by the same author in his dissenting opinion in *Industrial Accident Commission of the State of California v. Rolph Company,* 264 U. S. 219, 44 S. Ct. 302, 68 L. Ed. 646 at 657, where a great many

cases are cited in which the United States Supreme Court has reversed its former holdings on constitutional issues.

In our case there has been a change since the former action was dismissed. The change may be considered as a change of facts or a change of law or what Mr. Chief Justice Hughes speaks of in the *Blair* case *infra* as the creation of a "new situation" and then *res judicata* fails.

The case of *Blair v. Commissioner of Internal Revenue,* 300 U. S. 5, 57 S. Ct. 330, 81 L. Ed. 465—decided February 1, 1937, makes clear that any subsequent change in the law operating on the first judgment renders *res judicata* ineffective. In that case the beneficiary of a trust who had assigned the income thereof was held liable for federal income taxes for a certain year on the income assigned. This was a decision of the United States Circuit Court of Appeals which had become final through denial of certiorari by the United States Supreme Court. The decision was predicated upon the law of Illinois holding that the trust was a spendthrift trust and therefore the assignment was invalid. After the judgment had become final, the Illinois courts held the trust was not a spendthrift trust and that the assignments were valid. The United States Supreme Court held that the *Tait* case (a primary reliance of appellants herein, see brief of Florence Moore, pp. 9, 11, 12, 16) was not applicable and that *res judicata* with respect to taxes in later years could not be upheld, saying, at page 469 (of L. Ed.):

> "* * * we think that the ruling in the Tait Case is not applicable. That ruling and the reasoning which underlies it apply where in the subsequent proceed-

ing, although relating to a different tax year, the questions presented upon the facts and the law are essentially the same. Tait v. Western Maryland R. Co. supra (289 U. S. pp. 624, 626, 77 L. Ed. 1408, 1409, 53 S. Ct. 706). *Here after the decision in the first proceeding, the opinion and decree of the state court created a new situation.* The determination of petitioner's liability for the year 1923 had been rested entirely upon the local law. Commissioner of Internal Revenue v. Blair (C. C. A. 7th), 60 F. (2d) 340, 342, 344. The supervening decision of the state court interpreting that law in direct relation to this trust cannot justly be ignored in the present proceeding so far as it is found that the local law is determinative of any material point in controversy."

In *Freeman on Judgments,* Fifth Ed. Vol. 2, Sec. 713, the rule is stated as follows:

"* * * Generally, however, a subsequent change in the law applied in arriving at the judgment defeats its operation as res judicata so far as dependent upon the continuance of that law."

"The estoppel of a judgment extends only to the facts in issue as they existed at the time the judgment was rendered, and does not prevent a reexamination of the same questions between the same parties where in the interval the facts have changed or new facts have occurred which may alter the legal rights or relations of the litigants. But in the absence of evidence to the contrary the facts as they existed at the time of the former judgment will be presumed to continue." (34 *Corpus Juris* 905.)

In *Third National Bank of Louisville v. Stone,* 174 U. S. 432, 19 S. Ct. 759, 43 L. Ed. 1035, it is held a decree

establishing the existence of an irrevocable contract exempting or limiting the taxation of a bank for the term of its original charter is not *res judicata* as to whether the bank is subject to taxation after that charter is renewed. Compare this with *Gunter v. Atlantic Etc. R. Co.*, 200 U. S. 273, 26 S. Ct. 252, 50 L. Ed. 486, also heavily relied on by appellants, where there had been no change of law or fact after the first judgment.

In *City of Shreveport v. Shreveport Rys. Co.*, 38 Fed. (2d) 945, 69 A. L. R. 340, it is held that a judgment upholding the validity of an ordinance requiring street cars to be manned by two persons, as applied to the conditions then existing and presented to the court, are not *res judicata* in a subsequent suit by the railway company against the city to enjoin the enforcement of the ordinance, where conditions have sufficiently changed to render the ordinance unreasonable and unnecessary, and its enforcement would operate to confiscate the company's property.

In *Quannah, A. & P. Ry. Co. v. Panhandle & S. F. Ry. Co.*, 67 Fed. (2d) 826, at page 828:

> "The contention of estoppel by judgment arises out of a proceeding between the same parties to restrain the revocation of a similar joint route and rate for other products filed May 15, 1933, and dismissed May 31, 1933, on the ground that the matter was within the exclusive jurisdiction of the Commission. That bill did not present and could not have presented, any question based on the Emergency Railway Transportation Act, for it became law more than two weeks after the judgment."

Snyder v. Commissioner of Internal Revenue, 73 Fed. (2d) 5, at page 6:

"The Commissioner of Internal Revenue found a deficiency tax against Snyder arising out of marginal transactions in the year 1928 which were similar in character to marginal transactions of the same taxpayer in 1925 on which this court passed in Snyder v. Commissioner, 54 F. (2d) 57. The Commissioner claims the decision in that case is res judicata of the matter raised on the present petition. Although the law may be the same, the facts, though similar, are different and, being different, they were not passed upon in that case. We hold against the Commissioner's contention of res judicata." (Affirmed *Snyder v. Commissioner of Internal Revenue,* 295 U. S. 134, 79 L. Ed. 1351, 55 S. Ct. 737.)

Stone v. Interstate Natural Gas Co., 103 Fed. (2d) 544, page 547:

"But the judgment would be no estoppel if the parties were the same, for the tax here involved is under a new and different law. The taxes imposed are similar, but the Legislature made the substitution in order to accomplish changes, especially a new and strange definition of 'doing business' discussed below, and the changes are sufficient to require a new determination" (certiorari was granted June 5, 1939).

Marcum v. Marcum, 70 Fed. (2d) 760, held:

Judgment in first contempt proceeding holding court was without power to punish husband for contempt for failure to pay counsel fees and costs allowed in divorce decree *held* not res judicata in subsequent contempt proceeding based on same default, where first judgment was erroneous under subsequent appellate court decision.

See also the following:

United Shoe Machinery Corp. v. United States, 258 U. S. 451, 42 S. Ct. 363, 66 L. Ed. 708;

L. R. A. 1918D page 253;

Bank of Eureka v. Partington, 91 Fed. (2d) 587, Ninth Circuit (July 28, 1937).

It is clear from the foregoing that the cases cited by appellants are readily distinguishable, and that none of them bear upon the issues here.

No man can acquire a vested right by way of estoppel as against a change in the constitution or fundamental law.

Recently the Supreme Court has limited or overruled former holdings with respect to the liability of state employees for federal income taxes and of federal employees for state income taxes (*Helvering v. Gerhardt,* 304 U. S. 405, 58 S. Ct. 969, 82 L. Ed. 1427).[17] Appellants would argue that if in some former holding, a state employee (e. g. Mr. Brush in *Brush v. Commissioner,* 300 U. S. 352, 57 S. Ct. 495, 81 L. Ed. 691, 108 A. L. R. 1428) had successfully defended an attempt by the Federal Government to collect income taxes he would be forever exempted from income taxes, notwithstanding the subsequent limitation of the rule. A decree that a minimum wage law fixed by state statute for women and children is unconstitutional would, according to appellants, excuse compliance with the law in perpetuity notwithstanding the Supreme Court reversed itself in *West Coast Hotel Co. v. Parrish,* 300

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17. In the more recent case of *Graves v. People of New York, ex rel. O'Keefe,* 306 U. S. 466, 59 S. Ct. 595, 83 L. Ed. (Adv. Op.) 577, an employee of the H. O. L. C. was held subject to state income tax and former decisions are overruled.

U. S. 379, 57 S. Ct. 578, 81 L. Ed. 703. Innumerable other examples might be cited not only in the instances noted by Mr. Justice Brandeis, *supra,* but in many other cases decided in recent years where the Supreme Court has changed the law on constitutional matters relating to all manner of property rights.

3. There is still another answer to the claim of *res judicata.* The clear effect of subdivision (h) of Section 83 is to provide: that judgments of dismissal based on old section 80 shall not be *res judicata* under the new law. That is the plain intent of the language used. There is no reason why Congress in a bankruptcy proceeding cannot define the effect to be given to a former judgment in bankruptcy. In doing so it is merely prescribing procedure in the bankruptcy court, with respect to which, as has been pointed out, its power is plenary.

ANSWER TO TENTH PROPOSITION: "CHAPTER IX OF THE BANKRUPTCY ACT IS VOID AS APPLIED TO APPELLANTS".

(a) As Here Applied the Bankruptcy Act Does Not Prefer Junior Liens to Senior Liens or Discriminate Among Liens of Equal Rank.

The Act provides for the approval of a plan for the composition of debts of the taxing agency.

Because *some* of the lands in the District are subject to mortgages or bonds of other independent and distinct public agencies it is claimed the effect of this proceeding is to prefer junior liens and to discriminate among claims of equal rank; and further, that Chapter IX is not a law "on the subject of bankruptcies" (App. Brief, p. 104).

Here again appellants fly squarely in the teeth not only of the *Bekins* case, 304 U. S. 27, 58 S. Ct. 811, 82 L. Ed. 1137, which held the contrary, but of the *Ashton* case, 298 U. S. 513, 56 S. Ct. 892, 80 L. Ed. 1309, which assumed that the law was adequately related to the "subject of bankruptcies". Furthermore, the points of appellants on this and kindred issues were unsuccessfully raised in the briefs in the *Bekins* case and in *Luehrmann v. Drainage Dist. No. 7,* 104 F. (2d) 696, reviewed *supra,* pp. 54 et seq.

But it is not true that Chapter IX prefers junior liens to senior liens or discriminates among liens of equal rank. The obligations of mortgages or bonds of overlapping agencies are simply not affected by the plan.

The most that can be said in support of appellants' position is, that if the obligations of the Merced Irrigation District are scaled down it leaves more money in the pocket of the taxpayer to pay other obligations. But this has no bearing upon the validity of the law or its application.

The argument of appellants reduces itself to the absurd. They say the Merced Irrigation District cannot compose its own debts (obviously it has no authority to compose mortgage debts or the debts of independent agencies) because the effect is to scale down the obligation of the taxpayer and he therefore has greater ability to pay assessments of other public agencies. These agencies, improvement districts, school districts, etc. must then be brought in and declared bankrupt and that leaves the landowner with more money to pay on his mortgage and it follows that all mortgagees must be summoned. So the obligations of the mortgagees are scaled down and the

man is left with more money to pay the butcher, the baker and the candlestick maker and they too must come to court. So what appellants really are arguing is that you cannot scale down the obligations of the Merced Irrigation District without declaring all the inhabitants in the county bankrupt and adjusting all debts of a public and private nature.

Judge McCormick in his opinion in this case below, 25 Fed. Supp. 981, page 988, gives further reasons why appellants fail on the evidence and the facts relating to the overlapping liens. He points out that the aggregate amount of all other outstanding bonds so far as can be ascertained from the evidence is

> "relatively so small" and the "land within the district affected by such other outstanding bonds is so ununiform in relation to the area covered by the outstanding bonds of the district as to make it impracticable and inadvisable to require that such other obligations be taken into account in this proceeding * * *" He further points out that if the "collateral debts" must be considered and adjusted, the "delay and difficulties" will "destroy the efficacy" of the Act.

Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482, 33 S. Ct. 554, 57 L. Ed. 931, relied on by appellants, contains nothing in conflict herewith; nor does the more recent decision of *Case v. Los Angeles Products Co.* discussed *supra,* pp. 55 et seq.

(b) The California Statute Consenting to This Proceeding (Chap. 72, Cal. Stats. 1939) is Valid. It Does Not Impair the Obligation of Contract. It Merely Gives State Consent to This Proceeding.

The Supreme Court did *not* hold in the *Bekins* case, 304 U. S. 27, 58 S. Ct. 811, 82 L. Ed. 1137, as appellants say, that Sections 81-84 of the Bankruptcy Act could not be applied "unless the State in question has consented". It said (82 L. Ed. 1142),

> "It is unnecessary to consider the question whether Chapter X would be valid as applied to the irrigation district in the absence of the consent by the state which created it, for the state has given its consent."

Passing this, however, it is manifest that the *Bekins* case is direct authority that the mere *consent* of the state does not impair the obligation of the contract because the decision is predicated upon the assumption that the state *cannot* impair the obligation of the contract and if the *consent* by the state was "impairment", the decision would necessarily have been the other way. Aside from this, however, all the state does in consenting is to waive the privilege which it might have of objecting. As pointed out by Mr. Justice Cardozo in his dissenting opinion in the *Ashton* case, 298 U. S. 513, 56 S. Ct. 892, 80 L. Ed. 1309, at page 1320:

> "Any interference by the states is remote and indirect."

(c) The State Does Not Surrender Its Sovereign Powers by Consenting.

Appellants advance the strange doctrine that by consenting to this proceeding the state surrenders its sovereignty. The *Bekins* case directly holds the contrary:

> "It is of the essence of sovereignty to be able to make contracts and give consents bearing upon the exertion of governmental power." (82 L. Ed. p. 1144.)

As pointed out in detail by Mr. Chief Justice Hughes, the giving of consent by a state is not the surrender of sovereignty but the exercise of sovereignty.

The judgment should be affirmed.

Dated, Sacramento, California,
November 27, 1939.

Respectfully submitted,

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(Appendices A and B Follow.)

Appendices A and B.

Appendix A

EXCERPT FROM U. S. DEPT. OF AGRICULTURE REPORT.

Year and month	Index of prices received by farmers [August 1909—July 1914=100]								Ratio of prices received to prices paid
	Grains	Cotton and cotton-seed	Fruits	Truck crops	Meat animals	Dairy prod-ucts	Chickens and eggs	All groups	
1920	232	248	191	....	174	198	223	211	105
1921	112	101	157	....	109	156	162	125	82
1922	106	156	174	....	114	143	141	132	89
1923	113	216	137	....	107	159	146	142	93
1924	129	212	125	150	110	149	149	143	94
1925	157	177	172	153	140	153	163	156	99
1926	131	122	138	143	147	152	159	145	94
1927	128	128	144	121	140	155	144	139	91
1928	130	152	176	159	151	158	153	149	96
1929	120	144	141	149	156	157	162	146	95
1930	100	102	162	140	133	137	129	126	87
1931	63	63	98	117	92	108	100	87	70
1932	44	47	82	102	63	83	82	65	61
1933	62	64	74	105	60	82	75	70	64
1934	93	99	100	103	68	95	89	90	73
1935	103	101	91	125	118	108	117	108	86
1936	108	100	100	111	121	119	115	114	92
1937	126	95	122	123	132	124	111	121	93
November	85	65	88	124	120	132	135	107	84
December	86	64	76	112	111	136	127	104	83
1938—January	91	66	70	101	110	128	113	102	81
February	89	68	68	121	110	121	94	97	77
March	85	70	69	107	117	117	93	96	77
April	82	71	68	117	114	110	93	94	75
May	79	71	77	99	111	103	98	92	74
June	77	68	73	99	116	98	99	92	74
July	72	71	79	115	123	101	103	95	77
August	62	69	78	91	115	102	105	92	75
September	63	69	75	98	117	104	118	95	79
October	60	72	70	108	111	107	124	95	[5] 79
November	60	73	71	98	111	109	131	94	[5] 78

[5] Preliminary.

Appendix B

PREAMBLE, CHAPTER 24 STATUTES OF CALIF. 1937.

Sec. 1. "The Legislature of the State of California does hereby find, determine and declare to exist a State emergency affecting the peace, health, safety and comfort of the people, caused by and resulting from the inability of irrigation districts formed, organized and existing under the laws of this State to consummate and complete plans for liquidating, refinancing or readjusting indebtedness of such districts, and that such emergency arises out of the following facts, to wit:

That many of such districts were organized during a rapid period of expansion and inflated values and that they issued bonds in excess of their capacity to pay. That during the period of world-wide depression many of these districts became increasingly unable to meet the obligations of their bonded indebtedness, including the payment of interest thereon, and that mounting defaults in such districts with consequent pyramiding of assessments to the point of confiscation, ever increasing delinquencies and inability to sell lands foreclosed by the districts caused a condition of chaos to exist which resulted in the enactment of Chapter 60 of the Statutes of 1933 and Chapter 36 of Statutes of 1935, commonly known as 'Section 11 of the Districts Securities Commission Act'. That this act authorized, subject to the provisions thereof, the levy of assessments during the period of the emergency thereby declared to exist, based upon the ability of the land to pay and contemplated that, with such relief, ordinary economic processes would permit such districts to rehabili-

tate themselves through enabling them and the bondholders in agreement to work out refinancing plans before all values within such districts should be destroyed. That after the passage of said acts districts levied assessments based on the ability of lands to pay, and commenced proceedings to work out refinancing plans with their respective bondholders. That in many of such districts refinancing plans have heretofore been accepted by an overwhelming majority of the bondholders and proceedings have been brought under section 80 of the Bankruptcy Act of the United States to compel acceptance of such refinancing plans by small minority groups of dissenting bondholders. That recently the Supreme Court of the United States has held that such section of the Bankruptcy Act is unconstitutional in that it infringes upon the sovereignty of the States. That as a result of this decision there is now no legal procedure by which refinancing of the present bonded indebtedness of such districts may practicably be consummated. That the excessive debt burden of such districts has so increased and pyramided during the last three years, due to the inability to meet the annual debt obligations, that any present attempt to levy assessments designed to meet such obligations of such districts in full would result in overwhelming delinquencies, would prove largely uncollectible, would raise no adequate funds for bond or other debt service, and would be of no benefit to bondholders or creditors. That, unless these existing chaotic conditions are remedied, in each succeeding year an ever increasing body of lands will default in payment of assessments and will remain unredeemed therefrom. That annual assessments in each succeeding year will fall

upon a progressively lessening body of land which in turn will be forced to default in greater and greater quantities. That such inevitable and wholesale conditions of default will destroy the ability of such districts to pay their bonded debts in whole or in part and to carry out the necessary public functions with which they are entrusted as governmental agencies of the State. That on the contrary if refinancing plans now under way and accepted by overwhelming majorities of the bondholders of such districts can be effected, bondholders and creditors will be benefited, land in the districts will remain in private ownership, values will be restored and such districts will be enabled to discharge their public obligations. That the adequate credit, support and maintenance of such districts as governmental agencies of the State is a matter of vital State interest and concern; that the welfare of the State, the solvency of its banking institutions and the interests of the property owners in, and the creditors of, such districts, all require the speedy settlement and adjustment of the debt defaults of all such districts so that the financial standing, credit and tax collecting ability thereof may be restored * * *"